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Preface

This book is intended as a practical guide for trustees of California trusts and the lawyers who represent and advise them. It covers the trustee's initial and ongoing responsibilities, with particular attention to administrative problems that commonly arise and to the trustee's legal duties. Sample letters, charts, petitions and other court documents, and spreadsheets are provided throughout the book. In addition, recognizing that many problems encountered in the administration of trusts require pragmatic solutions, the authors have provided an abundance of practical advice.

As a special practice aid, the book includes two chapters, 13 and 14, that provide complete step-by-step guides for administration of a revocable trust after the death of a single settlor and for allocating assets and funding subtrusts on the death of the first spouse to die.

CEB owes a special debt of gratitude to all of the authors of this book. Practicing attorneys who specialize in estate planning, they gave generously of their time and expertise. Each author is listed on the title page and at the beginning of his or her chapter.

CEB also gratefully acknowledges the contributions of the following attorneys, who served as consultants for this edition or as authors of recent update material used in this edition, and who reviewed and commented on chapter manuscripts or portions of chapter manuscripts. Their valuable insights and suggestions have made the book more accurate, more practical, and more reflective of California practice:

James P. Bessolo, Vice President and Trust Counsel, Northern Trust Bank of California N.A., Los Angeles

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In addition, Sandra Price, author of chapter 12, wishes to acknowledge the contribution of Clarence J. Ferrari, Ferrari Ottoboni LLP, San Jose, whose chapter in California Decedent Estate Practice (Cal CEB 1986), served as the basis for chapter 12 in this book.

David B. Gaw, author of chapters 13 and 14, wishes to acknowledge that his chapters were the result of efforts of various lawyers in the law firm of Gaw, Van Male, Smith, Myers & Miroglio. Mr. Gaw would like to acknowledge the contributions by other lawyers of the firm: Christine L. Craig, S. Scott Reynolds, Mark A. Hyjek (formerly of the firm), and David A. Diamond (formerly of the firm). In addition to these contributions, the staff of Gaw, Van Male, Smith, Myers & Miroglio has been invaluable in assisting in this project. The staff members include Connie Denning, Melissa K. Scott (formerly of the firm), Lori A. Hunt, Donna J. Kiernan, Cathy L. Reynolds, and Diane M. Smith.

Finally, CEB gratefully acknowledges the contributions of the late Estelle E. Depper and of Amy J. Bernstein, authors of the first edition of this book.

Mary Gerber, CEB Attorney, was Project Manager and principal legal editor for this book. Jean Magistrale, Frederike Schilter, and Kate Sheppard served as legal editors. Legal research was provided by Jean Magistrale, Frederike Schilter, and Kate Sheppard. Kathryn Te Selle updated the index. Paul Green handled copy editing and production. Cynthia Kimberlin provided administrative assistance. Composition was performed by CEB's Electronic Publishing staff.

February 2010 Update

CEB gratefully acknowledges the contributions of the following attorneys, who served as authors of the February 2010 update: Alexandra Laboutin Bannon, Anglea & Bannon, Pasadena; David B. Gaw, Gaw, Van Male, Smith, Myers & Reynolds, Napa; Dibby Allan Green, ACP, Ambrecht & Associates, Santa Barbara; Margaret M. Hand, Oakland; Ann C. Harris, San Diego; James P. Lamping, Gaw, Van Male, Smith, Myers & Reynolds, Napa; Ruth A. Phelps, Phelps, Schwartz & Phelps, Pasadena; Bart J. Schenone, Schenone & Peck, Hayward; and May Lee Tong, Attorney at Law,

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Selected Developments

February 2010 Update

New chapter 13A (Administering Moderate Married Settlor Trust on the Death of the First Spouse) discusses the trust administration process when there is no need for the trustee to fund a marital deduction trust to avoid estate tax on the first death. The new chapter refers extensively to the existing discussion of single-settlor trusts (see chap 13) and married settlor trusts (see chap 14) with estate tax issues. The hypotheticals in those chapters and in chapter 7 reflect an assumed administration in 2010 based on a date of death in 2009 when the applicable exclusion amount was $3.5 million.

Chapters 10 and 10A have been reorganized. Chapter 10 (Creditor's Rights Against the Trust) provides a complete discussion of notice and claim requirements for the trustee and creditors of the deceased settlor after the settlor's death, including the optional trust claims procedure. Chapter 10A (Creditor's Rights Against Trust Beneficiary's Interest) concerns the ability of the beneficiary's creditors to reach the trust assets or trust distributions to satisfy claims against the beneficiary. The discussion of creditor's rights against the trust before the settlor's death has been moved to §§2.55A-2.55G.

The discussion in chapter 1 reflects new case law concerning representation of an individual client in both a personal and fiduciary capacity (*Baker Manock & Jensen v Superior Court* (2009) 175 CA4th 1414, 96 CR3d 785) and the potential liability of a drafting attorney who also represents the trustee (*Chang v Lederman* (2009) 172 CA4th 67, 82, 90 CR3d 758). See §§1.10-1.12.

The discussion in chapter 2 reflects new case law (*In re Stuart Cochran Irrevocable Trust* (Ind App 2009) 901 NE2d 1128) on the exercise of trustee discretion under the Uniform Prudent Investor Act. The case is also discussed in chapter 5. See §§2.44, 5.20.

The discussion in chapter 4 reflects new case law concerning the spousal exemption from the disqualified transferee statute (*Estate of Pryor* (2009) 177 CA4th 1466, 99 CR3d 895) that would also allow the surviving spouse to be sole trustee of the decedent's trust when the survivor would otherwise be disqualified. See §4.28.

The discussion in chapter 7 reflects new case law on the trustee's duty to keep beneficiaries reasonably informed of the trust and its administration under Prob C §16060 (*Salter v Lerner* (2009) 176 CA4th 1184, 99 CR3d 1) and amendments to the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) concerning the allocation of deferred compensation and similar payments from annuities or retirement plans under Prob C §16361.

The discussion of principal and income in chapter 8 also reflects these amendments to the UPAIA and reflects other amendments to the UPAIA concerning the allocation of income taxes paid by the trust under Prob C §16374. See §§8.24-8.24B, 8.35.

The discussion in chapter 9 reflects new case law regarding the right of the trustee to indemnity for expenses of administration from trust beneficiaries (*Kasperbauer v Fairfield* (2009) 171 CA4th 229, 88 CR3d 494) and the right of the trustee to attorney fees and costs incurred in requesting attorney fees and costs (*Guardianship of K.S.* (2009) 177 CA4th 1525, 100 CR3d 78) in trust accounting litigation with a favorable result under Prob C §17211(a). See §§9.20, 9.51.

The discussion in chapter 11 has expanded coverage of tax return preparer penalties under IRC §6694 (see §11.3A) and taxation of capital gains and losses under IRC §643(a) (see §§11.48-11.50).

The discussion in chapter 12 reflects new IRS guidance concerning requirements for bonds or liens in making an election to pay estate tax in installments under IRC §6166 (see §12.27) and final regulations restricting the ability of trustees to deduct contingent and unpaid expenses under IRC §2053 (see §12.41).

Changes to Forms: The update includes a new sample form of client memorandum entitled "Where to Put Receipts and From Where to Pay Expenses." See §14.25A.

The marital subtrust funding target and allocation spreadsheets in chapter 14 have been revised to reflect increases in the IRC §2010 applicable exclusion amount and in the IRC §2032A special use value reduction limitation. These amounts are $3.5 million and $1 million, respectively, for estates of decedents dying in 2009. The changes will allow married settlors to avoid estate tax on combined estates of $9 million, assuming both estates qualify for the special use valuation election. See discussion in §14.66.

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Cutoff Dates and CEB Citation

Cutoff Dates

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The Role of the Attorney

CEB Staff

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§1.1 I. ATTORNEY ACTING AS TRUSTEE

Attorneys are frequently asked to serve as trustees, but in light of Prob C §§15642, 21350-21350.5, it is doubtful they will wish to do so. Under these statutes, a drafting attorney is generally considered a "disqualified person" for purposes of acting as a sole trustee, and just being such a "disqualified person" may be grounds for removal. Prob C §15642(b)(6). On the various exceptions to disqualification, see §1.6. In addition, there are stringent rules regarding an attorney-trustee's compensation for acting in such dual roles. Prob C §15687. See §1.7. On the importance of full disclosure to the client and the potential for conflicts of interest in serving as trustee, see §§1.5, 1.8. Potential conflicts also may arise in serving as attorney for the trustee. See §§1.9-1.21.

The attorney may have familial or personal reasons for wishing to serve, however. In such instances, the attorney should still not accept the trusteeship unless he or she has the necessary time, expertise, and inclination to perform trustee duties. See §§1.2-1.4. With respect to the ability to perform the required duties, the attorney's decision on whether to serve as trustee must be based on the best interests of the trust. See Prob C §§16040-16042 (trustee's standard of care), discussed in §§2.49-2.52.

As a practical matter and depending on the circumstances of a particular trust administration, including the trustee's expertise, an attorney not serving as trustee may frequently end up performing tasks considered to be trustee duties, such as dealing with asset transfers. This is particularly true when there is a nonprofessional trustee.

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A. Practical Considerations

§1.2 1. Interference With Legal Practice

Attorneys first must consider the extent to which trustee duties will interfere with their legal practice. Proper management of a trust of any size or complexity requires a substantial amount of time. An attorney with an active law practice may find that trustee duties significantly interfere with work for other clients. Much bookkeeping work can be delegated, but any that is performed by the attorney's law office staff increases the office's operating expenses. When the bookkeeping is delegated to outside parties, the attorney-trustee must nevertheless take the time to review the work for accuracy. Meetings with the beneficiaries to resolve problems and explain the workings of the trust can be very time-consuming, and large blocks of time must be set aside to manage, inspect, and supervise certain assets, such as income-producing real property. Because time spent administering the trust is compensable to the attorney as a trustee, not as an attorney (Prob C §15687), remuneration may be significantly lower than the attorney normally receives for the same amount of time expended in providing legal services. See chap 9.

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§1.3 2. Liability to Other Members of Law Firm

The trustee actions of an attorney-trustee who is a member of a partnership or professional corporation are a potential liability to other members of the law firm. If a law firm is a general partnership, the partners are jointly and severally liable for the acts of any partner in carrying out the business of the partnership, and, depending on the circumstances, an attorney's fiduciary activities could be considered the business of the partnership. Corp C §16306(a). See *Blackmon v Hale* (1970) 1 C3d 548, 83 CR 194. If the law firm is a limited liability partnership, the protection against liability is broader, but under certain circumstances a partner may still be liable for another partner's errors and omissions in rendering legal advice. Corp C §16306(f). See Advising California Partnerships, chap 6 (3d ed Cal CEB 1999). Thus, other members of the firm should be consulted before an attorney accepts an appointment as trustee.

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§1.4 3. Level of Expertise Required

The knowledge required to manage a trust properly does not necessarily fall within the attorney's legal expertise. Although attorneys cannot necessarily claim particular expertise in the management of a trust because of their legal training and experience, many settlors nevertheless have a tendency to view the attorney as a professional trustee and accordingly expect a relatively high caliber of trust management. It is possible that a court may impose a higher standard of care on the attorney-trustee based on his or her presumed skills and the client's expectations. See Prob C §16014(b) (if, in selecting trustee, settlor relied on trustee's representations of having special skills, trustee is held to standard of skills represented). On the standard of care for a trustee with greater than average skill, see chap 2.

An attorney contemplating an appointment as trustee should review the clauses in his or her professional malpractice insurance policy to determine whether the policy covers the attorney's activities as trustee.

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B. Potential Ethical and Practical Problems

§1.5 1. Importance of Full Disclosure to Client

A settlor often feels that his or her attorney is the most qualified person to act as trustee. Although the California Rules of Professional Conduct do not expressly forbid accepting this appointment (see Cal Rules of Prof Cond 3-300 and 3-310), both ethical considerations and practical problems often make this a task to be avoided. An attorney who decides to serve as trustee must reconcile the duties he or she owes to the client under the California Rules of Professional Conduct with the trustee duties under Prob C §§16001-16005, including the duties to deal impartially with all the beneficiaries and to avoid conflicts of interest.

Therefore, attorneys considering becoming trustee of a trust created by a client should be especially careful to disclose to the client in writing all relevant information, including:

- The duties of the trustee;
- The qualifications necessary to act as trustee;
- A detailed explanation of language in the trust instrument that exculpates the trustee;
- The fees the attorney is likely to charge for acting as trustee;
- The tasks the attorney expects to delegate to others;
- The fees likely to be charged for the delegated tasks;
- The fact that the attorney intends to employ legal representation for himself or herself in certain situations; and, if applicable,
- The fact that the attorney intends to hire his or her own law firm as the trustee's attorney (see §1.7).

Because clients normally place a high degree of confidence in their attorneys, it is more important for an attorney to disclose this information than it would be for any other individual trustee. It is especially important that the attorney disclose the tasks expected to be delegated and the fees likely to be charged for these tasks, because the client may be assuming that the attorney (unlike a friend or relative chosen as trustee) will personally perform all trustee duties.

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Source: Estate Planning/California Trust Administration/1 The Role of the Attorney/§1.6 2. When the Drafting Attorney May Serve as Trustee

§1.6 2. When the Drafting Attorney May Serve as Trustee

The attorney who drafts the trust instrument for the client generally is disqualified from serving as the sole trustee of the trust, as is any partner, shareholder, or employee of a law firm in which the drafter has an ownership interest, because the attorney is a disqualified person. See Prob C §§15642(b)(6), 21350(a)(1), (3), 21350.5.

NOTE: The drafter of a will or trust instrument is not a disqualified person under Prob C §21351(i) if the document is not signed in California and the testator or settlor was not a California resident when it was signed, as might occur if the attorney is asked to draft a trust and serve as successor trustee for an out-of-state settlor because, for example, the remainder beneficiaries of the trust reside in California. See *Estate of Clementi* (2008) 166 CA4th 375, 82 CR3d 685 (will prepared by beneficiary executed in Pennsylvania by testator who died a California resident).

In addition to the Probate Code restrictions, the American Bar Association's Model Rules of Professional Conduct expressly state that an attorney should not prepare an instrument that gives the attorney or a member of the attorney's immediate family any substantial gift from the client. ABA Model Rules of Prof Cond 1.8(c). See also ABA Model Rules of Prof Cond 7.3 (attorney may not solicit professional employment when significant motive is the attorney's pecuniary gain). California Rule of Professional Conduct 4-400 forbids the attorney from inducing the client to make a substantial gift to the attorney or to the attorney's close family unless the attorney and client are related. A gift may not be accepted if there was undue influence. See *Magee v State Bar* (1962) 58 C2d 423, 24 CR 839.

The attorney who drafted the trust instrument, or a partner, shareholder, or employee of the drafter's firm, may nevertheless serve as sole trustee under any of the following circumstances (Prob C §15642(b)(6)):

- The court finds that it is consistent with the settlor's intent that the trustee continue to serve and that this intent was not due to fraud, menace, duress, or undue influence, based on evidence of the settlor's intent and all other facts and circumstances;
- The attorney-trustee is not a disqualified person because the settlor was related by blood or marriage to, or was a cohabitant with, the attorney-trustee who drafted the trust instrument (Prob C §§15642(b)(6)(A), 21351(a));
- The attorney-trustee is not a disqualified person because the trust instrument was reviewed by an independent attorney who counseled the settlor about his or her intended trustee designation and signed and delivered to the settlor and the designated trustee a "Certificate of Independent Review" in the form set forth in Prob C §15642(b)(6)(B) (see Prob C §21351(b)); or
- After full disclosure of the relationships of the persons involved, the attorney-trustee is not a disqualified person because the trust instrument is approved by an order under Prob C §2580 issued on a petition for substituted judgment in a conservatorship proceeding (Prob C §§15642(b)(6)(C), 21351(c)).

Taking into consideration the various relevant provisions, the attorney should never suggest that he or she be named trustee and, when asked to act as trustee, should accept only after full disclosure in writing to the client of all relevant information, including a restatement of the client's reasons for wanting the attorney to be trustee. The attorney should consider recommending that the settlor review the trust (and the estate plan) with another attorney, especially when there is the possibility of opposition by beneficiaries.

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Source: Estate Planning/California Trust Administration/1 The Role of the Attorney/§1.7 3. Prohibition Against Dual Compensation

§1.7 3. Prohibition Against Dual Compensation

An attorney-trustee can appear personally for routine court proceedings on trust matters. The attorney-trustee cannot, however, be compensated for services both as an attorney and as a trustee unless the attorney obtains approval for the right to dual compensation as provided in Prob C §15687(d). Prob C §15687(a). The trustee may hire attorneys even if they are associated or affiliated with the trustee, to advise or assist the trustee in the performance of administrative duties. Prob C §16247. However, no parent, child, sibling, or spouse of a person who is a trustee, and no law partnership or corporation whose partner, shareholder, or employee is serving as a trustee, shall receive any compensation for legal services performed for the trustee unless the trustee waives trustee compensation or unless the trustee obtains approval for the right to dual compensation as provided in Prob C §15687(d). Prob C §15687(b). See chap 9 for discussion of the procedure prescribed by Prob C §15687 and for sample forms.

NOTE: Even if the trust instrument specifically allows dual compensation, the attorney-trustee must still comply with Prob C §15687 before being allowed to take fees in both capacities. The statute is based on the public policy of not allowing an attorney to place himself or herself in a potential conflict of interest (by self-hiring to obtain dual compensation) without making disclosure to the beneficiaries and giving them an opportunity to be heard.

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§1.8 4. Potential for Conflicting Duties or Interests

A trustee must be free to act impartially in the best interests of all beneficiaries. Prob C §16003. An attorney, however, is under a duty to act in the best interests of his or her client. See *Flatt v Superior Court* (1994) 9 C4th 275, 36 CR2d 537 (duty of loyalty); Cal Rules of Prof Cond 3-310. See also Comment to ABA Model Rules of Prof Cond 1.7 (loyalty as essential element of attorney's relationship to client). When the attorney-trustee represents or has represented the settlor, the possibility of conflict is minimal because, in most cases, the trustee and the settlor have the same goals.

When an attorney-trustee represents or has represented any of the beneficiaries, however, it may be impossible for the attorney-trustee to act or appear to act impartially. In California, the attorney-trustee faced with potential or actual conflicting interests may continue to represent all interested clients with their informed, written consent. Cal Rules of Prof Cond 3-310. See §§1.17-1.19.

The trustee has a duty not to take part in any transaction in which the trustee has an interest adverse to the beneficiaries. Prob C §16004(a). An attorney-trustee, however, may take part in trust transactions in which he or she has an interest adverse to the beneficiaries if the beneficiaries consent with full knowledge of the facts and the attorney-trustee's motivations, and the transaction itself is fair and reasonable. Prob C §§16463 (consent), 16464 (release), 16465 (affirmation). See also Cal Rules of Prof Cond 3-310(B) discussed in §1.21. This situation, however, should be avoided. No matter how carefully the attorney-trustee works to fairly discharge his or her fiduciary obligations to all beneficiaries, some beneficiaries will tend to assume that the client's interests are preferred over theirs. Also, full consent is frequently impossible to obtain because of unborn or unascertained beneficiaries. But see Prob C §15405 (guardian ad litem may consent for beneficiaries who lack legal capacity).

Although the law firm of which an attorney-trustee is a member may represent the settlor or the beneficiaries under the trust with the informed, written consent of these clients (see Cal Rules of Prof Cond 3-310), the firm must be able to provide independent, disinterested advice to the client whenever a conflict arises between them and the attorney-trustee. Its ability to do so could be compromised by the presumption that it has an interest in protecting the position of the firm member who is the trustee. See ABA Model Rules of Prof Cond 1.10. Also, the firm may be unable to represent the settlor-client or the beneficiary-client in any legal action against the trustee because the presumption could arise that the firm has access to information about the trust's operations that would otherwise be unavailable to them. See Comment to ABA Model Rules of Prof Cond 1.10.

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II. ATTORNEY FOR TRUSTEE

§1.9 A. Selecting the Attorney: The Trustee's Choice

An individual or corporate trustee may select any attorney and change representation at any time. Prob C §16247 (trustee has authority to hire persons, including attorneys). In selecting an attorney, the trustee is subject to the prudent person standard: The trustee must act for the benefit of the trust estate and use appropriate care, skill, and caution. Prob C §16040. If the trustee fails to use reasonable prudence in selection and retention of the attorney for the trust, the trustee is liable for acts or omissions of the attorney that constitute a breach of trust. Prob C §16401(b)(3). In some cases, the attorney may be asked to serve as trustee. See §§1.1-1.8.

Corporate trustees typically retain the attorney who drafted the trust instrument or the attorney who represented the probate estate from which the trust was created, on the theory that this attorney would have been the settlor's choice. Situations arise in which a trustee decides to retain a different attorney from the one who drafted the trust instrument or represented the probate estate when:

- The family of a settlor expresses a strong preference for another attorney;
- The trustee believes the attorney has a conflict of interest;
- The trustee believes the attorney lacks specialized legal skills needed for a particular problem; or
- The trustee believes the settlor had changed attorneys after the instrument was drafted.

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§1.10 B. Determining Who Is the Client and Establishing the Attorney-Client Relationship

Identifying the client provides a starting point for analysis of any sensitive issues or other factors involved in the potential representation. Because trust administration involves not only beneficiaries who may have conflicting interests, but also possibly omitted heirs, creditors, and other third parties, the attorney must evaluate whether representation is appropriate, whether conflicts of interest preclude representation, and whether concerns regarding confidential information need to be addressed. These issues can be especially critical when the attorney has previously represented members of the family in estate planning matters.

When an attorney has had some role in the affairs of the family or has represented individual or corporate fiduciaries in the past, the attorney must carefully determine whether past representation or receipt of confidential information prevents representation of the individual or corporate trustee in the administration of the trust. Similarly, as the administration of a trust proceeds, representation of the client in his or her fiduciary capacity, in which duties may exist in favor of other parties, may conflict with potential representation of the client in his or her individual capacity, *e.g.,* as a beneficiary. Accordingly, the attorney must analyze not only the initial client relationship with the trustee but also any anticipated individual role the client may assume to determine the scope and propriety of representation. See *Baker Manock & Jensen v Superior Court* (2009) 175 CA4th 1414, 96 CR3d 785, in which the court held that a law firm that drafted the decedent's estate plan should not have been disqualified from representing the personal representative, in either the representative's personal or fiduciary capacity, in litigation against another beneficiary of the estate. The fact that the firm drafted the estate plan did not cause the other beneficiary to become a client of the firm to whom the firm would owe a duty of loyalty. According to the decision, the fact that a drafter may be liable to the beneficiary for the drafter's negligence does not make the beneficiary a client of the drafter, nor does the beneficiary become a successor client when the decedent dies. See discussion of liability in §1.12.

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§1.11 C. Existence of Attorney-Client Relationship in Absence of Formal Agreement

Even if the parties do not enter into an engagement agreement or other formal arrangement and the attorney declines to represent the proposed client, an attorney-client relationship may nevertheless exist. The attorney has a duty to maintain client confidences and secrets. Bus & P C §6068(e); State Bar Committee on Prof Resp & Cond Formal Opinion 1993-133; *Goldstein v Lees* (1975) 46 CA3d 614, 120 CR 253.

The key to determining the existence of an attorney-client relationship is whether legal advice is given—even if the recipient never retains the attorney. See *Beery v State Bar* (1987) 43 C3d 802, 239 CR 121; *Miller v Metzinger* (1979) 91 CA3d 31, 154 CR 22. Thus, for example, if the attorney has had informal discussions with a client's spouse or family members and either provided advice or received confidential information, a conflict of interest could arise should the attorney represent the trustee.

Informal preliminary discussions may lead to a party's expectation that the attorney has been retained to provide legal services. To prevent the unintended creation of an attorney-client relationship, the attorney should consider sending the prospective client a nonengagement letter.

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§1.12 D. Responsibilities of Attorney for Trustee

An attorney is required to perform legal services competently, *i.e.,* to apply diligently the learning and skill necessary to perform his or her duties arising from employment or representation. Cal Rules of Prof Cond 3-110(A)-(B). If an attorney lacks the requisite competence, he or she can nevertheless satisfy the competence requirement by either (1) associating with or professionally consulting another attorney reasonably believed to be competent; or (2) acquiring sufficient learning and skill before performance is required. Cal Rules of Prof Cond 3-110(C).

The duty of skill and care implies the potential for liability to the trustee-client for claims from beneficiaries. See *Bucquet v Livingston* (1976) 57 CA3d 914, 129 CR 514. But see *Chang v Lederman* (2009) 172 CA4th 67, 82, 90 CR3d 758 (attorney for trustee had no duty to advise surviving spouse of homestead provisions or duty of care to the spouse as potential beneficiary in earlier drafting client's estate plan). In *Chang v Lederman*, the court held that a disappointed beneficiary cannot sue an attorney who declined to draft estate plan amendments allegedly desired by the attorney's dying client. The court stated that a drafting attorney owes no duty to a beneficiary unless the drafted documents are executed and expressly confer benefits on the complaining beneficiary, but fail to deliver those benefits because of the attorney's negligence. For further discussion of liability of the drafting attorney (who is often the attorney for the trustee) to trust beneficiaries, see Drafting California Revocable Trusts §§2.21-2.26 (4th ed Cal CEB 2003); California Trust and Probate Litigation §§17.54-17.55 (Cal CEB 1999).

Once having agreed to represent a trustee, an attorney should maintain regular contact to stay adequately informed about the actual management of the trust. The attorney might discover that the trustee is unaware of certain requirements or responsibilities imposed by the position. Even though the attorney may have conducted an initial discussion with the trustee when the trust was created, an occasional reminder may be necessary to prevent misunderstandings, particularly as to the necessity of preparing required tax returns (see chaps 11, 12), communicating with beneficiaries (see chaps 2, 7), and filing accountings (see chap 7).

The trustee's attorney must see to it that the trustee's actions in regard to any litigation are appropriate. Unless the trustee has a legitimate interest in the controversy, he or she should not participate in the litigation. See *Estate of Huber* (1973) 31 CA3d 126, 134, 107 CR 89 (corporate trustee and its attorney denied compensation from the trust estate when corporate trustee had no legitimate interest in the controversy between the income beneficiary and the remainder beneficiaries).

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Source: Estate Planning/California Trust Administration/1 The Role of the Attorney/§1.13 E. Role of Attorney for Trustee if Litigation Arises

§1.13 E. Role of Attorney for Trustee if Litigation Arises

Although the attorney for the trustee may have substantial experience in routine trust administration, litigation requires a whole set of additional skills if the attorney is to meet the standard of Cal Rules of Prof Cond 3-110. See §1.12. The attorney should be knowledgeable about and experienced not only in the substantive area of law involved in the dispute, but also in general civil litigation procedures, and procedures unique to the proceeding and court trying the matter. The attorney can satisfy the requirements of Cal Rules of Prof Cond 3-110 by:

- Delegating the matter to another member of the attorney's firm who is competent to handle the litigation;
- Associating litigation counsel (see §1.14); or
- Referring or transferring the matter to litigation counsel (see §1.15).

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§1.14 1. Association of Other Counsel

In an association arrangement, both the initial attorney and the litigation attorney are the attorneys for the trustee-client for purposes of the litigation and both are listed as attorneys of record on the litigation pleadings. An association arrangement is suitable when, for example, the initial counsel has substantial litigation skill and experience and can properly handle (and wants to handle) the bulk of the pretrial litigation work but wants to associate litigation counsel for the purposes of developing and supervising litigation strategy and handling the trial if the litigation cannot be settled. Association is also appropriate when initial counsel has substantial litigation skill and experience but is a sole practitioner and needs to associate another attorney or firm in order to have the resources to handle major litigation.

The initial attorney and the trustee should discuss their prospective relationship with respect to the associated attorney and the litigation. For example, there should be an understanding about whether the associated attorney will remain in the background as an advisor or be in direct contact with the trustee-client and actively involved in the litigation. The initial attorney should have a written fee agreement with the specialist, delineating their separate responsibilities. Typically, the initial attorney is responsible for supervising associated counsel's work and ensuring that the client is satisfied.

The trustee must consent in writing to the dual representation and to any division of attorney fees. Cal Rules of Prof Cond 2-200(A)(1). Under this rule, the total fee may not be unconscionable (as defined in Cal Rules of Prof Cond 4-200) and may not be increased solely because of the division of fees. The fee division need not be made on the basis of the proportion of services rendered by the lawyers as long as the lawyers assume responsibility for the representation as a whole and the trustee is advised about and consents in writing to the arrangement. See *Moran v Harris* (1982) 131 CA3d 913, 182 CR 519 (court upheld fee-splitting arrangement between referring lawyer and lawyer actually rendering services).

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§1.15 2. Referral to Other Counsel

If the initial counsel is not in a position to bring any value to the litigation effort, the extra cost of an association arrangement (*e.g.,* duplicate sets of pleading and discovery documents, and time spent for conferences between administrative counsel and litigation counsel) may not be in the client's best interest. Referral is dictated when the initial counsel does not wish to assume direct professional liability for proper management of the litigation effort.

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§1.16 F. Representing Cotrustees

In the majority of cotrustee arrangements, the same attorney represents all the trustees. Independent counsel is necessary under some circumstances, however, *e.g.,* when trustees disagree on a course of action to be taken. Trustees and their attorneys are entitled to compensation from the trust estate for multiple representation when it is in the best interests of the trust. See *Estate of Scott* (1905) 1 CA 740, 83 P 85. In any situation involving multiple representation of cotrustees, the attorneys must not only make sure that their clients are acting in the best interests of the trust, but also that the trust will not be subjected to unnecessary legal fees because of the multiple representation. The attorneys should make sure that routine legal duties such as preparation of reports and accounts, reviews of assets, and other noncontroversial matters are shared in some equitable fashion.

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§1.17 G. Conflicts of Interest in Multiple Representation

Conflicts of interest may arise in trust proceedings due to the interrelatedness of parties and the multiple roles of individual parties as beneficiaries, fiduciaries, or business associates. Often, these roles can shift during the course of the proceedings. A common potential conflict arises, *e.g.,* when the settlor is serving as trustee, the beneficiaries are members of the settlor-trustee's family, and the attorney representing the settlor-trustee has also represented family members in other legal matters for many years. In this situation, the attorney should not represent the family members with respect to their interests in the trust.

NOTE: Even attempting to limit representation of family members to nontrust matters may be impossible, especially if the attorney is likely to gain information that would affect his or her representation of the trustee and violate Cal Rules of Prof Cond 3-310. See *Estate of Huber* (1973) 31 CA3d 126, 134, 107 CR 89.

Other common scenarios in which a conflict of interest may arise in trust matters include representation of a trustee and a beneficiary (see *Estate of Huber, supra*) and representation of the trustee and one of the beneficiaries in controversy with other beneficiaries (see *Morales v Field, DeGoff, Huppert & MacGowan* (1979) 99 CA3d 307, 316, 160 CR 239).

An attorney must be able to advise and represent the trustee without being concerned about how this obligation will affect another current or former client, or any personal interest of the attorney. See Cal Rules of Prof Cond 3-310(B) (attorney must not accept employment from or represent an interest adverse to current or former clients without informed, written consent). See also ABA Model Rules of Prof Cond 1.7-1.9. The attorney must also make sure that family ties do not lead the trustee and the attorney to participate in a controversy in which the trustee has no legitimate interest. See *Estate of Huber, supra*.

For a discussion of the conflicts of interest that frequently arise in trust administration, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel (State Bar of California Trusts and Estates Section, 2008 ed).

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§1.18 1. Rules on Multiple Representation When Clients' Interests Potentially Conflict

When an attorney represents more than one client in a matter, the attorney-client engagement letter must address these conflicting duties in a manner consistent with Cal Rules of Prof Cond 3-310(C). That rule provides:

> A member shall not, without the informed written consent of each client: (1) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict; or (2) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict; or (3) Represent a client in a matter and at the same time in a separate matter accept as a client a person or entity whose interest in the first matter is adverse to the client in the first matter.

The attorney must comply with Rule 3-310(C) regarding both potential and actual conflicts. If no potential or actual conflict exists, Rule 3-310(C) does not apply. An attorney representing more than one client should be alert for possible conflicts of interest throughout the entire period of representation. If multiple representation initially appears appropriate but interests diverge or an actual conflict arises during the course of representation, the attorney must inform the parties in writing of the nature of the conflict and its foreseeable consequences. The attorney should obtain the parties' informed written consent to continued representation despite any prior consents that the parties may have granted. Cal Rules of Prof Cond 3-310(C)(1)-(2).

When clients have conflicting interests, an attorney cannot solve the problem by withdrawing from representing one client in order to continue representing the other. Because of the duty of loyalty to each client, the attorney cannot represent either. See *Truck Ins. Exch. v Fireman's Fund Ins. Co.* (1992) 6 CA4th 1050, 8 CR2d 228.

In addition to the requirements of Rule 3-310(C), the attorney for the trustee has a duty of undivided loyalty to the client. See *Flatt v Superior Court* (1994) 9 C4th 275, 36 CR2d 537 (duty of loyalty to first client precludes attorney's simultaneous or dual representation of second client in matter adverse to first client, even if matter is unrelated to attorney's representation of first client). See also *Cal W. Nurseries v Superior Court* (2005) 129 CA4th 1170, 29 CR3d 170 (duty of loyalty to first client precluded attorney's representation of second client as against other parties in unrelated action in which second client was adverse to first client by virtue of cross-complaint). In addition to avoiding representation of adverse interests (Cal Rules of Prof Cond 3-310), the attorney must maintain client confidences and secrets (Bus & P C §6068(e); State Bar Committee on Prof Resp & Cond Formal Opinion 1993-133; *Goldstein v Lees* (1975) 46 CA3d 614, 120 CR 253).

NOTE: On the attorney-client privilege in the trust context, see California Trust and Probate Litigation §10.76 (Cal CEB 1999). Additionally, the trustee's attorney should not represent a business enterprise that is part of the trust assets if the needs of the business conflict with those of the trustee.

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§1.19 2. When Informed Written Consent Is Required

If a potential or actual conflict exists either at the beginning of the attorney-client engagement or later arises during the course of representation, Cal Rules of Prof Cond 3-310(C) applies and requires the attorney to obtain the clients' written consent to initial or continued representation after disclosure of the material facts. Even if the attorney obtained the clients' written consent when a potential conflict existed or arose, another written consent is required if the potential conflict becomes an actual conflict.

Informed written consent is also required when the attorney has obtained confidential information material to the employment from representation of the client or former client. Cal Rules of Prof Cond 3-310(E).

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§1.20 3. Practical Problems of Representing Multiple Parties

Realistically, in the context of trust matters, particularly when litigation might arise, tactical and interpersonal considerations make it unlikely that the parties will consent to their former attorney representing a potentially adverse party. The issue is more likely to arise when an attorney seeks to represent multiple parties who appear to be on the same side, but whose interests may actually or potentially conflict in more subtle ways. An attorney may, for example, seek to represent all parties who share a common interest in a trust matter, particularly when a contingency fee agreement is required and the trust is divided among multiple heirs. Some of these parties, however, may have distinctly different legal positions or may receive different or contingent classes of assets. A widow challenging or defending a trust may have community property interests that conflict with her children's or other relatives' interests in the trust.

Although it may make strategic and economic sense to have a potential client join with other relatives and heirs to share fees and expenses or payment of a contingency, the attorney should first analyze whether there are conflicts among the parties. Any conflicts should be resolved in advance, or the parties must agree in writing, after full disclosure, to waive the actual or potential conflicts. An attorney who fails satisfactorily to clear conflicts may not only be subject to liability to clients and face possible disciplinary action for an ethical violation, but may be unable to settle the matter because one or more of the clients demands satisfaction of his or her personal desires as a precondition to consent to the settlement.

Even if the parties' interests are not directly in conflict, disparate abilities to pay current fees or costs may cause serious conflicts. When several clients demand settlement of trust matters because of their financial plight while their well-heeled relatives urge litigation of potential problems, the attorney may find the conflict incapable of resolution. One possible solution is for the fee agreement to provide that decisions will be made by persons holding a majority of the interests (defined in terms of numerical majority or dollar amount).

The parties may also have divergent views on the public airing of skeletons in the family closet, *e.g.,* infidelity, abuse, mental illness, or chemical dependency. If the attorney seeks advance agreement in the fee contract on mechanisms for obtaining majority decisions from client groups, the contract should disclose the possibility of clashes of personal as well as financial values.

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Source: Estate Planning/California Trust Administration/1 The Role of the Attorney/§1.21 4. Rules on Multiple Representation Under Cal Rules of Prof Cond 3-310(B)(1)-(4)

§1.21 4. Rules on Multiple Representation Under Cal Rules of Prof Cond 3-310(B)(1)-(4)

An attorney may not accept or continue representation of a client without providing written disclosure to the client if the attorney (Cal Rules of Prof Cond 3-310(B)(1)-(4)):

- Has a legal, business, financial, professional, or personal relationship with a party or witness in the same matter;
- Knows or reasonably should know that the attorney previously had a legal, business, financial, professional, or personal relationship with a party or witness in the same matter and that that relationship would substantially affect the representation;
- Has or had a legal, business, financial, professional, or personal relationship with another person or entity who the attorney knows, or reasonably should know, would be substantially affected by resolution of the matter; or
- Has or had a legal, business, financial, or professional interest in the subject matter of the representation.

NOTE: In contrast to the conflict-of-interest rules in Cal Rules of Prof Cond 3-310(C) (see §1.18), Rule 3-310(B) requires written disclosure but not informed written consent. Disclosure is not limited simply to a prior legal representation; the attorney must disclose a "legal, business, financial, professional, or personal relationship" with a party or witness.

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2

Overview of Trustee's Duties, Standards, and Powers

Paul J. Barulich

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I. TRUSTEE'S DUTIES

§2.1 A. Trustee's Duties and Standard of Care

The trustee's actions are governed by a statutory framework that sets forth his or her obligations in the form of duties, including the trustee's primary duties of loyalty (see §§2.21-2.40A) and impartiality (see §§2.41-2.48), the standard of care necessary to measure compliance with those duties (see §§2.49-2.52), and the powers that enable the trustee to act to carry out the duties and conduct the affairs of the trust (see §§2.53-2.76). Prob C §§16000-16249. The trustee's performance is measured against this framework, subject to permissible, variant terms of the trust instrument. On the duty to administer the trust according to its terms, see §§2.2-2.3. On the trustee's duties to account and furnish information, see §§2.4-2.12. On the duty of confidentiality, see §§2.13-2.17. On the delegation of duties, see §§2.18-2.20. The chapter also discusses registration requirements for professional fiduciaries. See §2.77-2.82.

Educating a nonprofessional trustee about these fiduciary duties is an important responsibility of the attorney. Trustee powers and duties should be discussed with the settlor during the estate planning process and with the successor trustee (if possible) before or immediately after the commencement of trust administration on the death of the settlor. The attorney should be aware that the surviving settlor or other successor trustee is likely to retain little of the previous instruction provided by the attorney during the estate planning process.

The instruction of the trustee should include a review of trust law and the trust instrument in the context of planning for administration of the trust. If the attorney will have a continuing role in trust administration, planning must include the division of responsibilities between the attorney and trustee.

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B. Duty to Administer Trust According to Its Terms

§2.2 1. Determining Settlor's Intent From Trust Instrument

Under both California law and common law, the trustee is under a duty to administer the trust according to its terms. Prob C §16000. See *Penny v Wilson* (2004) 123 CA4th 596, 20 CR3d 212 (failure to administer trust according to its terms rendered acts of trustee nonbinding). See also *Stanton v Wells Fargo Bank & Union Trust Co.* (1957) 150 CA2d 763, 310 P2d 1010; 3 Scott & Ascher on Trusts §16.1 (5th ed 2007). In general, the trustee need look only at the written trust document and properly executed amendments to determine the precise terms of the trust. The decree of distribution defines and limits the powers of a trustee of a testamentary trust. *Shipley v Jordan* (1929) 206 C 439, 274 P 745; *Kaiser v Gibson* (1968) 264 CA2d 319, 70 CR 246. See also *Meyer v Meyer* (2008) 162 CA4th 983, 76 CR3d 546 (no-contest clause that was not included in decrees of distribution did not apply to testamentary trust). However, the trustee must not comply with any term that is contrary to public policy. See Prob C §15203 (illegal trust purpose); Prob C §15642 (grounds for removal of trustee); Prob C §15687 (limitations on trustee compensation for legal services); Prob C §16060 (duty to furnish information); Prob C §16061.7 (duty to provide notice); Prob C §16062 (duty to report and account); Prob C §16461 (limitations on certain trustee liability).

Both living and testamentary trust instruments must be interpreted according to the intention of the settlor as expressed in the instrument. Prob C §21102(a). See *Newman v Wells Fargo Bank* (1996) 14 C4th 126, 59 CR2d 2; *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639. In construing a trust document, the guiding principle must be the intention of the settlor as expressed. "Not, What did he intend to say? but, What did he intend by what he did say? must be the test." *Kropp v Sterling Sav. & Loan Ass'n* (1970) 9 CA3d 1033, 1044, 88 CR 878, quoting *Title Ins. & Trust Co. v Duffill* (1923) 191 C 629, 642, 218 P 14. See §2.3 on extrinsic evidence.

Except as modified by "the settlor and all beneficiaries" (Prob C §15404) or by court order (Prob C §§15403, 15408, 15409, 17200(b)(13)), the purposes declared at the trust's creation must be followed by the trustee. Prob C §16000. Once a trust becomes irrevocable, it is almost impossible, even with the settlor's consent, to modify it without court approval because of the probability that "all beneficiaries" will include minor, unborn, and unascertainable beneficiaries. See Prob C §24(c). See also chap 16.

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§2.3 2. Extrinsic Evidence of Settlor's Intent

Extrinsic evidence of the settlor's intent may be considered only when the trust instrument is unclear or ambiguous. *Kropp v Sterling Sav. & Loan Ass'n* (1970) 9 CA3d 1033, 1045, 88 CR 878. Although extrinsic evidence may be introduced to ascertain what is meant by the person using the words in question, it cannot be used to show that the words in issue meant something to which they were not reasonably susceptible under all the circumstances. *Wells Fargo Bank v Marshall* (1993) 20 CA4th 447, 24 CR2d 507; *Levy v Crocker-Citizens Nat'l Bank* (1971) 14 CA3d 102, 94 CR 1. See CCP §1856. See also Prob C §15207 (proof of terms of oral trust). Trusts do not share the same statutory authority as wills for use of extrinsic evidence. See Prob C §6111.5. Most California courts, however, have long ignored this distinction and have readily allowed use of extrinsic evidence to bring clarity to unclear or disputed provisions of the testamentary instrument. For a detailed discussion of extrinsic evidence, see California Trust and Probate Litigation §§18.27-18.31 (Cal CEB 1999). On letters of instruction from the settlor, see §2.3A. On the trustee's duty to follow written directions from the settlor of a revocable trust, see §2.3B.

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§2.3A 3. Settlor's Letter of Instructions

Occasionally, a settlor writes a letter before execution of the trust outlining how the trustee should administer the trust, *e.g.,* telling the trustee to consider the needs of the surviving spouse to be of primary importance when making discretionary distributions. Following an instruction that has not been written into the instrument puts the trustee at peril. But to disregard it places the trustee in an uncomfortable situation if, *e.g.,* the spouse claims that the letter mentioned above clearly showed the settlor's intent, notwithstanding the absence of similar provisions in the trust instrument. A trustee may wish to consider petitioning the court for instructions on the effect of documents other than the trust instrument—*e.g.,* letters from the settlor or references to the settlor's oral declarations—particularly if there is a controversy with one or more beneficiaries. See §15.26.

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§2.3B 4. Duty to Follow Written Directions From Settlor of Revocable Trust

Probate Code §16001(a) requires the trustee of a revocable trust to follow all written directions acceptable to the trustee from the person then having the power to revoke the trust or from the person to whom the settlor has delegated the right to direct the trustee. If the written direction would have the effect of modifying the trust, the trustee has no duty to follow the direction unless it complies with the requirements for modifying the trust. Prob C §16001(b). See also Prob C §§15401 (method of revocation by settlor) and 15402 (power to revoke includes power to modify). For further discussion, see chap 16.

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C. Duties to Account and Furnish Information

§2.4 1. Duty to Account

The trustee is generally required to account, at least annually, at termination of the trust, and, on a change of trustee, to each beneficiary to whom income or principal is required or authorized in the trustee's discretion to be currently distributed. Prob C §16062. See Prob C §16063 and §§7.53-7.65G for required contents of accounts. See also Prob C §17200(b)(7), which authorizes an action to compel the trustee to report or account to the beneficiary if the trustee has failed to submit a report or account within 60 days after a written request from the beneficiary and no report or account has been made within the previous 6 months. On waiver of accounting, see §2.4A. On trusts created by instruments executed before July 1, 1987, see §2.4B. On court accounts for trusts funded by court order, see §2.4C. On revocable trusts, see §2.4D. The trustee is also required to furnish information regarding the trust to the beneficiaries under Prob C §§16060-16061.9. See §§2.5-2.12.

In *Patton v Sherwood* (2007) 152 CA4th 339, 61 CR3d 289, the court held that a charitable trust settlor who was not a trustee and had no rights to receive distributions had standing to object to trust accountings because the trust document expressly gave the settlor the power to compel accounts. However, the settlor generally is not entitled to accounts unless the settlor is a beneficiary of the trust.

In *Esslinger v Cummins* (2006) 144 CA4th 517, 50 CR3d 538, the court held that a trust remainder beneficiary had standing to petition for an order compelling the trustee to provide annual accounts for prior years. The court noted that a beneficiary who is not entitled to an account under Prob C §16062 may be entitled to a "particular account" under Prob C §16061. See Comment to Prob C §16061.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.4A a. Waiver of Accounting

§2.4A a. Waiver of Accounting

The duty to account does not apply if the trust instrument waives an accounting or if the beneficiary has waived in writing the right to a report or account; however, the court may compel the trustee to report information about the trust and to account, regardless of a waiver of accounting in the trust instrument, on a showing that it is reasonably likely that a material breach of the trust has occurred. Prob C §16064(a).

NOTE: A trust instrument may contain specific language relieving the trustee of liability for a breach of trust if the beneficiary fails to object to the trustee's account or report within a specified period of time, which cannot be less than 180 days. Prob C §16461. See §7.65.

Probate Code §16062(e) provides that any limitation or waiver in a trust instrument of the obligation to account is against public policy and void for any sole trustee who is a disqualified person as defined in Prob C §21350.5 (limitations on transfers to persons having a specified relationship with the transferor).

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§2.4B b. Trusts Created by Instruments Executed Before July 1, 1987

The trustee of a living trust created by an instrument executed before July 1, 1987, need not account under Prob C §16062. Prob C §16062(b). The trustee of a testamentary trust created by a will executed before July 1, 1987, likewise need not account under §16202 unless the trust has been removed from continuing court jurisdiction under Prob C §17350, in which case the trustee must generally account. Prob C §16062(c).

Prior law still applies to testamentary trusts created by a will executed before July 1, 1977, that have been removed from continuing court jurisdiction under the provisions of former Prob C §1120.1a. The trustee of such a trust must provide to each income beneficiary and to remainder beneficiaries who have made a written request an annual statement of income and principal receipts and disbursements and an annual summary of the trust assets. Nonetheless, the duty to account under former Prob C §1120.1a may be satisfied by furnishing an account that satisfies the requirements of Prob C §16063. Prob C §16062(d). See chap 7 for a detailed discussion of the trustee's duty to account, both to beneficiaries and to the court.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.4C c. Trusts Funded by Court Order

§2.4C c. Trusts Funded by Court Order

Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons) and that will have total assets of more than $20,000 after receipt of those funds—the trust instruments must require the trustee to file accounts and reports for court approval in the manner and frequency prescribed by Prob C §§1060-1064 and §§2620-2628. Cal Rules of Ct 7.903(a)(1), (c)(6), (d). For further discussion of court accounts, see §§7.66-7.124.

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§2.4D d. No Duty While Trust Is Revocable

The duty to account under Prob C §16062 generally does not apply if the trust is currently revocable. See *Johnson v Kotyck* (1999) 76 CA4th 83, 90 CR2d 99 (when there is duly appointed conservator for incapacitated settlor of revocable trust, beneficiaries cannot directly obtain accounting from trustee of conservatee's trust). However, the trustee of a revocable trust other than the settlor may later be compelled to account for transactions that occurred over the entire period of the trust if the trustee served before the settlor's death while the trust was still revocable. *Evangelho v Presoto* (1998) 67 CA4th 615, 79 CR2d 146.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/ 2. Duty to Furnish Information/§2.5 a. Duty to Keep Beneficiaries Informed and Furnish Copy of Trust Terms on Request

2. Duty to Furnish Information

§2.5 a. Duty to Keep Beneficiaries Informed and Furnish Copy of Trust Terms on Request

The trustee has an affirmative duty to keep the beneficiaries of a trust reasonably informed of the trust and its administration. Prob C §16060. Unlike the duty to account (Prob C §16062) and the duty to furnish reports discussed in §2.6 (Prob C §16061), this duty to inform is nonwaivable. See *Salter v Lerner* (2009) 176 CA4th 1184, 1188, 99 CR3d 1, citing California Trust and Probate Litigation §13.1 (Cal CEB 1999). See also Restatement (Third) of Trusts §82 (2007).

When a revocable trust or any portion of it becomes irrevocable because of the death of one or more of the settlors of the trust, or because by the express terms of the trust the trust becomes irrevocable within 1 year of the death of a settlor because of a contingency related to the death of one or more of the settlors of the trust, the trustee must notify the beneficiaries (see §2.7) and must provide a complete copy of the terms of the irrevocable trust, or irrevocable portion of the trust, to any beneficiary of the trust and any heir of a deceased settlor who requests it. Prob C §16061.5(a). Under the terms of Prob C §16061.5(a), there is no obligation to provide a complete copy of the terms of an irrevocable trust, or irrevocable portion of a trust, if the trust becomes irrevocable during the settlor's lifetime, except in a situation in which the settlor attempts to defeat the basic purpose of the statute by providing, for example, that the trust becomes irrevocable on the day before a settlor's death.

The trustee has discretion to make a good faith determination by any reasonable means of the heirs of a deceased settlor in the absence of a final judicial determination of heirship known to the trustee. Prob C §16061.5(b).

NOTE: As used above, "terms of the trust" does not include documents that were intended to affect disposition only while the trust was revocable. Also, if a trust has been completely restated, "terms of the trust" does not include trust instruments or amendments that are superseded by the last restatement before the settlor's death, but it does include amendments executed after the restatement. Prob C §16060.5.

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§2.6 b. Duty to Furnish Report of Information to Beneficiary on Reasonable Request

In addition to the requirements of Prob C §16061.5, the trustee is required, on reasonable request by a beneficiary, to provide the beneficiary with a report of information about the assets, liabilities, receipts, and disbursements of the trust, the acts of the trustee, and the particulars relating to the trust that are relevant to the beneficiary's interest. Prob C §16061. Like the trustee's duty to account under Prob C §16062, the duty to furnish information may be waived by the trust instrument or by the beneficiary and is generally not available to a beneficiary of a revocable trust (see Prob C §15800). Prob C §16064. However, Prob C §16064(a) provides that no waiver described in Prob C §16062(e) is valid or enforceable. See §2.4A. Probate Code §16064(a) also authorizes the court to compel the trustee to report information about the trust and to account regardless of waiver. See also Prob C §17200(b)(7), which authorizes an action to compel the trustee to report information to a beneficiary on request.

The beneficiary is entitled to know the nature of the trust property and how it is managed, at least as it is relevant to the beneficiary's interest. Accordingly, the trustee must make available to the beneficiary all relevant records of the trust, with some exceptions. A major exception is matter subject to an attorney-client or attorney work-product privilege. A trustee can keep beneficiaries "reasonably informed" and provide "a report of information" without necessarily having to disclose privileged communications. *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 207, 91 CR2d 716.

The beneficiary requesting information must give sufficient notice to the trustee. Without reasonable advance notice, an individual trustee could be severely inconvenienced by having to be present when a beneficiary is reviewing the records. Similarly, a corporate trustee needs sufficient time to gather the necessary records for the beneficiary to inspect. Although inconvenience is not a sufficient reason to deny the beneficiary's request to inspect the records (*Strauss v Superior Court* (1950) 36 C2d 396, 403, 224 P2d 726), unreasonableness on either side would not play well with the court. The trustee should be present when the beneficiary is reviewing the files. If the beneficiary wants copies of trust records, this expense may be properly borne by the trust. See Prob C §15684.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.7 c. When Notification Required

§2.7 c. When Notification Required

Under Prob C §16061.7(a), a trustee must serve a notification on specified persons on the occurrence of the following events:

- When a revocable trust or any portion of it becomes irrevocable
- because of the death of one or more of the settlors of the trust or
- because by the express terms of the trust the trust becomes irrevocable within 1 year of the death of a settlor because of a contingency related to the death of one or more of the settlors of the trust. Prob C §16061.7(a)(1).
- When there is a change of trustee of an irrevocable trust. It is the duty of the continuing or successor trustee to serve the notification. If there are cotrustees, any cotrustee may serve the notification. Prob C §16061.7(a)(2).

Note that, when the notification is triggered by a change of trustee, notification is given only to the beneficiaries (and to the Attorney General if the trust is a charitable trust); there is no requirement that heirs be notified. See §2.8. On service of the notification, see §2.9. The notification must include the information in Prob C §16061.7(g) and must include the warning in Prob C §16061.7(h) unless the notification is served only because of a change of trustee. See §2.10. Any waiver by a settlor of the requirement of serving the notification is against public policy and is void. Prob C §16061.7(i). On the penalty for failure to serve the notification, see §2.11. On limitations on actions after service of notification, see §2.12.

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§2.8 (1) Who Is Entitled to Notification

The notification must be served on each of the following (Prob C §16061.7(b)):

- Each beneficiary of the irrevocable trust or irrevocable portion of the trust, subject to the limitations of Prob C §15804;
- Each heir of the deceased settlor, if notification is required either
- because of the death of a settlor or
- because by the express terms of the trust the trust becomes irrevocable within 1 year of the death of a settlor because of a contingency related to the death of one or more of the settlors of the trust; and
- The Attorney General, if the trust is a charitable trust as defined in Prob C §16100 and IRC §4947(a) (*i.e.*, not a split-interest trust) subject to the supervision of the Attorney General.

Probate Code §16061.7(c) states that the trustee shall rely on a judicial determination of heirship known to the trustee, but that will rarely be available to the trustee within 60 days of the death of a settlor. In the absence of a final judicial determination known to the trustee, questioning family members or going through address books or other personal papers of a deceased settlor may provide evidence of a "good faith determination by any reasonable means" of the heirs as required by Prob C §16061.7(c). Nonetheless, without a more definitive standard, a trustee may be subject to challenge if an heir is omitted.

The trustee, however, need not provide a copy of the notification to any beneficiary or heir whose existence is known to the trustee but who cannot be located by the trustee after reasonable diligence, or who is unknown to the trustee. Prob C §16061.7(d).

A trustee may serve a notification in the form required by Prob C §16061.7 on any person in addition to those on whom the notification is required to be served. A trustee is not liable to any person for serving or not serving the notification on any person on whom the notice is not required to be served. Prob C §16061.7(j).

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.9 (2) When and How Notification Must Be Served

§2.9 (2) When and How Notification Must Be Served

The notification must be served by mail to the last known address or by personal delivery. Prob C §16061.7(e). The notification must be served no later than 60 days after the occurrence of the event requiring service of the notification, or 60 days after the trustee becomes aware of the existence of a person entitled to receive notification if that person was not known to the trustee at the time of the occurrence of the triggering event. Prob C §16061.7(f).

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§2.10 (3) Required Contents of Notification

The notification must contain the following information (Prob C §16061.7(g)):

- The identity of the settlor or settlors of the trust and the date of execution of the trust instrument;
- The name, mailing address, and telephone number of each trustee of the trust;
- The address of the physical location where the principal place of administration of the trust is located as defined in Prob C §17002;
- Any additional information that may be expressly required by the terms of the trust instrument;
- Notification that the recipient is entitled, on reasonable request to the trustee, to receive from the trustee a true and complete copy of the terms of the trust.

The notification also must include the following warning, set out in a separate paragraph in not less than 10-point boldfaced type or a reasonable equivalent, unless the notification is served only because of a change of trustee (Prob C §16061.7(h)):

> You may not bring an action to contest the trust more than 120 days from the date this notification by the trustee is served upon you or 60 days from the date on which a copy of the terms of the trust is mailed or personally delivered to you during that 120-day period, whichever is later.

For a discussion of what constitutes a "reasonable equivalent" of 10-point boldfaced type, see *Harustak v Wilkins* (2000) 84 CA4th 208, 100 CR2d 718 (when remainder of notice was in 12-point type, warning in 12-point type and not bolded or otherwise distinguished was insufficient). For a sample form, see §13.95.

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§2.11 (4) Penalty for Failure to Serve Notification

A trustee who fails to serve the notification as required by Prob C §16061.7 will be responsible for all damages, attorney fees, and costs caused by the failure unless the trustee makes a reasonably diligent effort to comply. Prob C §16061.9(a). With regard to an heir who is not a beneficiary and whose identity is known to the trustee, "reasonably diligent effort" means that the trustee has sent notice by first-class mail to the heir at the heir's last mailing address actually known to the trustee. Prob C §16061.9(b). In exercising discretion concerning the timing and nature of distributions of trust assets, a trustee may consider the fact that the period in which a beneficiary or heir could bring an action to contest the trust has not expired. Prob C §16061.9(c). See §2.12.

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§2.12 (5) Limitations on Actions When Notification Served

No person on whom the notification by trustee is served under Prob C §16061.7 may bring an action to contest the trust more than 120 days from the date the notification is served on him or her, or 60 days from the day on which a copy of the terms of the trust is mailed or personally delivered to him or her during that 120-day period, whichever is later. Prob C §16061.8.

NOTE: It is possible for the claims period to extend 180 days if the terms of the trust are disclosed on the last day of the 120-day claims period. Common practice to limit the claims period to 60 days requires that the trustee voluntarily disclose the terms of the trust in the initial notice given under Prob C §16061.7.

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D. Duty of Confidentiality

§2.13 1. Application of Duty Not to Disclose

The Restatement (Third) of Trusts §78, Comment i (2007) states that the trustee has a duty to not disclose to a third person information acquired as trustee when the trustee should know that the effect of the disclosure will be detrimental to the beneficiary's interest. This duty applies to the terms of the trust, the identity and interests of the beneficiaries, and the nature of the trust assets. This duty stems from one of the basic reasons individuals create trusts—to keep their affairs private. In California, this duty is not codified, except in Fin C §1582, which applies only to corporate trustees of "private trusts." See §2.14.

The extent to which trustees must practice confidentiality depends on several factors, one of which is whether a particular trust incident or transaction is a matter of public record. If it is, there is nothing to keep confidential. Usually the confidentiality factor depends on the type of trust. In court-supervised trusts, everything filed with the court is a matter of public record and need not be kept confidential, including accountings, petitions, and the trust instrument itself.

Testamentary trusts that are not supervised by the court produce few matters of public record. Unless a Prob C §17200 petition is filed during the course of trust administration, the instrument as set forth or referenced in the decree of final distribution may be the only matter of public information.

With revocable living trusts, which are not subject to continuing court jurisdiction, not even the trust instrument is filed with the court unless a Prob C §17200 petition is filed during the course of the trust's administration. In this event, the trust instrument, or a relevant portion of it, may be attached to the petition or incorporated in it, thereby becoming a matter of public record along with the matters in the petition. Prob C §17201. If confidentiality is a major consideration for the trust, the trustee may reconsider petitioning or defending a petition and may seek to limit how much of the instrument is disclosed. The trustee may be able to fashion proposed instructions that will help preserve confidentiality.

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§2.14 2. Financial Code Guidelines

Financial Code §1582, which applies only to corporate fiduciaries of private trusts, provides the only statutory guidance to California trustees on fulfilling their duty of confidentiality. Although §1582 does not apply either to individual trustees or to corporate trustees of testamentary trusts, both would probably assume less risk in following its guidelines than in following none at all. See §2.14A.

Under Fin C §1582, trustees must carefully review any request for information and the status of the person requesting it. The statute prohibits disclosure in the absence of an exception. However, it does not appear to require disclosure even if an exception exists. Nonetheless, most corporate trustees disclose if one of the exceptions applies. For example, the trustee of an irrevocable trust may provide information on the existence and terms of the trust to a beneficiary such as a contingent remainder beneficiary. A parent who is an income beneficiary of an irrevocable trust established by a grandparent may not want his or her child, the remainder beneficiary, to have any information about the trust. However, under Fin C §1582(e), the child may be given any information about the trust on request, even though his or her interest in it is a future interest.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.14A a. When Disclosure Permitted by Corporate Trustee of Private Trust

§2.14A a. When Disclosure Permitted by Corporate Trustee of Private Trust

Financial Code §1581 defines a "private" trust as any trust, agency, or fiduciary relationship or representative capacity other than a court trust; a "court" trust is defined as a trust for which the trust company acts under appointment, order, or decree of any court or for which it receives on deposit money or property from a fiduciary under court order. Financial Code §1582 prohibits a corporate trustee's disclosure to anyone of the existence, condition, management, or administration of a private trust, except in the following instances:

- When disclosure is authorized by the terms of the trust (Fin C §1582(a));
- When a trust officer determines that disclosure is necessary in the administration of the trust (Fin C §1582(b); see §2.14B);
- When disclosure is required by a court of competent jurisdiction or by a subpoena issued by an attorney under CCP §1985 (Fin C §1582(c));
- When disclosure is made to or on the instruction of a party executing the trust instrument (Fin C §1582(d));
- When disclosure is made to, or on the instructions of, a beneficiary of an irrevocable trust (including both vested and contingent remainder beneficiaries, as well as those holding a present interest) (Fin C §1582(e)); and
- When disclosure is made in the course of a bank examination (Fin C §1582(f)).

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§2.14B b. When Disclosure Necessary in Administration of Trust

All corporate trustees should determine on a case-by-case basis what is "necessary in the administration of [the] trust" (Fin C §1582(b)) so as to reconcile the statute with their duty of confidentiality. Most often, Fin C §1582(b) supports disclosure of some of the terms of a trust to a transfer agent, title company, or prospective lender to prove that the trustee has the authority to take an action. In such cases, the trustee should try to preserve the confidentiality of the dispositive provisions by disclosing only the sections required by the third party. Also, because the trustee most often works with others to provide proper management of the assets, these persons may need access to only *some* information concerning the trust. For example, although the trustee's accountant must have full knowledge of the trust terms and assets to do proper tax planning, the trustee should reveal only the beneficiaries' monetary needs and not their personal situations causing these needs.

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3. Certain Exceptions to Duty of Confidentiality

§2.15 a. Litigation Exception

The trustee's general duty of confidentiality is overridden by litigation. In general, issues of fact in probate proceedings are subject to the rules of practice in civil actions. Prob C §1000. Therefore, when the trustee is a party to litigation, whether as plaintiff or defendant and regardless of the forum, the rules of discovery override the basic duty of confidentiality. See *Coberly v Superior Court* (1965) 231 CA2d 685, 42 CR 64. Discovery proceedings defeat confidentiality whether the trustee is being sued individually for breach of trust or a third party is suing the trustee in his or her representative capacity. Therefore, anything normally discoverable—not only relevant matters but also matters that may lead to the discovery of admissible evidence—must be disclosed by the trustee on proper request of the opposing party. See CCP §2017.010. The attorney-client or attorney work product privilege may protect some information from disclosure.

The trustee may become involved in litigation but not be a party to the suit, *e.g.,* when a beneficiary is a party and information about the trust is relevant. This involvement often occurs in marital dissolution cases when the beneficiary's spouse wants to determine for computation of spousal or child support what assets are available to the beneficiary. Served with a subpoena duces tecum or notice of deposition, the trustee is required to produce documents or give testimony regarding matters that would otherwise be held confidential and so should immediately contact his or her attorney for specific advice on how much information must be disclosed. In most instances, the trustee should also immediately contact the beneficiary so that the beneficiary's attorney can oppose the request.

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§2.16 b. Duty Suspended by Government Regulations

Government regulations to which the trust is subject suspend the duty of confidentiality. For example, trust instruments must be filed with the federal estate tax return, and trusts must be disclosed to local governments to allow the county assessor to determine whether the real property titled in the name of the trustee must be reassessed under Proposition 13. In this situation, the confidentiality of the trust is protected to a degree by Rev & T C §481, which provides that the information given to the assessor must be used for this limited purpose and no other, except, as provided in Rev & T C §408, when a state or county investigates the assessor's office. The confidentiality of all tax returns is provided for under IRC §6103 (with certain exceptions, similar to the provisions of Rev & T C §408).

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§2.17 c. Statutory Disclosure of Trust Terms

When a revocable trust or any portion of a revocable trust becomes irrevocable because of the death of one or more of the settlors of the trust, or because by the express terms of the trust the trust becomes irrevocable within 1 year of the death of a settlor because of a contingency related to the death of one or more of the settlors of the trust, an heir of a deceased settlor who is not a beneficiary of the trust, among others, is entitled, on request, to receive a copy of the terms of the trust (as defined in Prob C §16060.5). Prob C §§16061.5(a), 16061.7. See discussion of notification in §§2.7-2.12.

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E. Delegation of Duties

§2.18 1. Duty Not to Delegate Noninvestment and Nonmanagement Functions

Except as otherwise provided in the trust instrument, and subject to Prob C §16052, which specifically allows delegation of investment and management functions if that is prudent under the circumstances (see §2.19), the trustee has a duty not to delegate to others the performance of acts that the trustee can reasonably be required to perform personally. Prob C §16012. Nor may a trustee delegate the entire administration of the trust to a cotrustee or other person. Prob C §16012. However, the trustee may employ agents to advise or assist the trustee in the performance of administrative duties, including accountants, attorneys, auditors, investment advisers, appraisers, or other agents. Prob C §16247.

Although many trusts have broad clauses authorizing the trustee to hire administrative employees, such clauses by themselves do not give the trustee the power to delegate acts that must be personally performed by the trustee. California courts have invoked a general guideline that employs a business-practice standard: A trustee must not delegate to others duties involving acts like those that an "average man of business" would consider so important to his own property and so much within his own capacity that he must perform them personally. See *Powers v Ashton* (1975) 45 CA3d 783, 789, 119 CR 729. For example, it would be appropriate for the trustee to allow a custodian to hold trust securities (corporate fiduciaries are specifically authorized by Fin C §1592 to use a securities depository), but the trustee should never delegate decisions on discretionary distributions to a third party because courts assume that the settlor or testator appointed that particular trustee because of his or her individual judgment concerning such matters.

A careless trustee, or one who has not been sufficiently educated about the duty not to delegate, might unwittingly delegate responsibilities that should be performed personally and could be liable for the consequences of any improper delegation. See §2.20. The key to avoiding unlawful delegation is for the trustee to remember that, although seeking advice is allowable, blindly following the advice is not. The trustee should seek advice when in doubt but make the final decision after independent analysis. *Estate of Talbot* (1956) 141 CA2d 309, 296 P2d 848; Restatement (Second) of Trusts §171 (1959); Restatement (Third) of Trusts §80 (2007); 3 Scott & Ascher on Trusts §17.3.2 (5th ed 2007). Particularly when advisers have been consulted, the trustee should document the decision process in the trust records to show that he or she actually made the decision.

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§2.19 2. Delegation of Investment and Management Functions

Probate Code §16012 (duty not to delegate) does not apply to investment and management functions. Prob C §16012(c). A trustee may delegate investment and management functions as prudent under the circumstances. Prob C §16052(a). This authorization to delegate is part of the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054). Probate Code §16052 provides special exceptions to the general rule concerning delegation (Prob C §16012) and the trustee's liability for acts of agents (Prob C §16401). Comment to Prob C §16052. See chap 5.

Delegation under Prob C §16052(a) is not limited to the performance of ministerial acts. In appropriate circumstances, delegation may extend, *e.g.,* to discretionary acts, to the selection of trust investments or the management of specialized investment programs, and to other activities of administration involving significant judgment. In appropriate circumstances, prudence may justify delegation of authority to an agent to establish the terms of transactions to be carried out under an agency arrangement that requires no further participation by the trustee. For a discussion on permissible delegation, see Restatement (Third) of Trusts §80 (2007). See also Restatement §90, Comment d.

The trustee is required to exercise prudence in selecting an agent and in establishing the scope and terms of the delegation. The trustee is also required to exercise prudence by periodically reviewing the agent's overall performance and compliance with the terms of the delegation. Prob C §16052(a).

Probate Code §16052(a) appears to authorize a trustee to delegate investment and management functions to a cotrustee, but not the administration of the trust. See Prob C §16402(b)(2) (list of acts of cotrustee for which trustee is liable). See also *Estate of Spirtos* (1973) 34 CA3d 479, 109 CR 919. With respect to the delegation of investment and management functions, except as otherwise provided in Prob C §16401, a trustee who complies with the requirements of Prob C §16052(a) is not liable for the decisions or actions of the agent to whom the functions are delegated. Prob C §16052(c).

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§2.20 3. Consequences of Improper Delegation

A trustee who improperly delegates an action is personally liable for the consequences if the act or omission would have been a breach of trust had it been committed by the trustee. Prob C §16401(b)(2). See also *Estate of Spirtos* (1973) 34 CA3d 479, 109 CR 919. This is true even when the trustee has acted in good faith, believing such action to be in the best interests of the beneficiary, and whether or not it was the trustee's surrender of control that caused the loss. *Gaver v Early* (1923) 191 C 123, 215 P 394. See also *Martin v Bank of America* (1935) 4 CA2d 431, 41 P2d 200.

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F. Duty of Loyalty

§2.21 1. Avoiding Conflicts of Interest

A primary fiduciary duty of the trustee is to administer the trust solely in the interest of the trust beneficiaries. Prob C §16002(a). See also Restatement (Third) of Trusts §78 (2007). For example, a trustee does not incur personal liability for distribution of trust assets to the beneficiaries and has no duty to preserve trust assets for the benefit of a creditor who has a claim pending against a deceased settlor's estate, but who has not obtained a judgment on the claim. *Arluk Med. Ctr. Indus. Group, Inc. v Dobler* (2004) 116 CA4th 1324, 11 CR3d 194, discussed in §10.10.

A corollary to this primary duty is that the trustee cannot engage in any act that puts personal interests in conflict with those of any of the trust beneficiaries. Prob C §16004(a). The duty of loyalty derives both from statute and common law. Prob C §16002. The prohibition against self-dealing applies regardless of the good faith of the trustee. *People v Larkin* (ND Cal 1976) 413 F Supp 978. The duty of loyalty also requires the trustee not to permit personal wishes or antagonisms to interfere with the discharge of the trustee's fiduciary duty. In *Hughes v Pair* (2009) 46 C4th 1035, 95 CR3d 636, for example, the court held that a trustee was not liable for sexual harassment when the trustee allegedly withheld authorization of rental payments on a residence occupied by a minor beneficiary to retaliate against the beneficiary's mother for resisting the trustee's sexual advances. However, the court did not consider the question of whether the trustee's actions might constitute a breach of the duty of loyalty to the beneficiary.

Notwithstanding the fact that avoiding conflict of interest is a natural corollary to the duty of loyalty governing the fiduciary obligation owed to all beneficiaries, a beneficiary can serve as trustee. *Crocker-Citizens Nat'l Bank v Younger* (1971) 4 C3d 202, 93 CR 214. This is common in marital deduction trusts in which the surviving spouse is the trustee. The potential for conflict is acute when the remainder beneficiaries are not issue of the decedent and surviving spouse. A trustee-beneficiary must be extremely careful not to let self-interest interfere with the proper administration of the trust.

Because corporate trustees could have difficulties in properly discharging their duty of loyalty because of their financial dealings with the trust itself or with beneficiaries outside of their fiduciary capacity, Prob C §16015 provides that it is not a violation of Prob C §16002 or §16004 for a regulated financial institution or its affiliates to furnish services for compensation in the ordinary course of business either to a trust for which it acts as trustee or to a person dealing with the trust. See also Prob C §16247 (allowing the trustee to hire associated or affiliated persons or agents to advise or assist with administrative duties). An existing conflict that cannot be cured may be grounds for removal of the trustee. See §2.39 on curing conflict-of-interest problems.

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§2.22 a. Self-Dealing

The most common type of conflict of interest and, accordingly, the most frequent violation of the duty of loyalty, is self-dealing by the trustee. This violation occurs when the trustee treats trust assets in some manner that potentially benefits him or her personally, even if there is no actual loss to the trust. *Estate of McLellan* (1936) 8 C2d 49, 63 P2d 1120; *Cagnolatti v Guinn* (1983) 140 CA3d 42, 189 CR 151. The rule is harsh; bad faith is not an element nor is good faith a defense. Generally, a transaction between the trustee and a beneficiary during the existence of the trust, or while the trustee has influence over the beneficiary, by which the trustee obtains an advantage is presumed to be a violation of the trustee's fiduciary duties. Prob C §16004(c). Self-dealing includes *any* means by which the trustee uses trust property for personal purposes or profit. Restatement (Third) of Trusts §78, Comment d (2007). The prohibition covers not only obvious violations, such as embezzlement and secret profits (*St. James Armenian Church v Kurkjian* (1975) 47 CA3d 547, 121 CR 214; *Strasberg v Odyssey Group, Inc.* (1996) 51 CA4th 906, 59 CR2d 474 (constructive trust imposed on assets concealed by fiduciary from beneficiary and held by auction house for sale)), but extends also to the use of trust assets for the trustee's personal convenience. For example, the trustee should not use property owned or leased by the trust for the purpose of conducting trust business to conduct personal business affairs. Technically, this prohibition includes even minor uses such as storage of the trustee's personal files or business records on premises paid for by the trust. The prohibition against self-dealing includes sales or leases of the trustee's property to the trust, sales or leases of trust property to the trustee, and a trustee's operation of a business competing with the trust. See §§2.23-2.25.

It is reasonable to assume the court would hold that a transaction between the trust and any member of the trustee's immediate family is a breach of the trustee's fiduciary duty. Also, the trustee should not have a third party purchase assets from the trust and then resell them to the trustee; such a "straw man" transaction is suspect. *Estate of Howard* (1955) 133 CA2d 535, 284 P2d 966; *Landis v First Nat'l Bank* (1937) 20 CA2d 198, 66 P2d 730.

For national bank trustees, the prohibition against self-dealing extends beyond the corporation itself to its subsidiaries and affiliates. 12 CFR §9.12. The prohibition against self-dealing investments (12 CFR §9.12(a)) and loans, sales, or other transfers from fiduciary accounts (12 CFR §9.12(b)) applies to officers, directors, and employees. Loans to a fiduciary account may be made only if the particular transaction is fair to the account (12 CFR §9.12(c)), and sales and loans between fiduciary accounts may be made only if the particular transaction is fair to both accounts (12 CFR §9.12(d)-(e)). Any of these transactions may be made only if the transaction is not prohibited by applicable law (defined in 12 CFR §9.2(b) to include state and federal law, terms of the governing instrument, and court orders). 12 CFR §9.12(c)-(e). There are additional exceptions regarding loans, sales, or other transfers from fiduciary accounts. 12 CFR §9.12(b).

A provision in the trust instrument allowing the trustee to self-deal will probably be sustained. See, *e.g., Estate of Thompson* (1958) 50 C2d 613, 328 P2d 1. Probate Code §16000 provides that the trust instrument can alter the standards set out in the code, but there are limited exceptions to this rule. See Prob C §§15687(e), 16061.7(i), 16062(e), 16461(b). See also §2.39 on curing conflicts.

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§2.23 (1) Purchase or Lease of Trust Assets by Trustee

A trustee may not deal with trust property for his or her own profit or for any other purpose unconnected with the trust (Prob C §16004(a)) even when no breach of trust has occurred. Restatement (Second) of Trusts §203 (1959).

A trustee who purchases or leases trust property is guilty of self-dealing under Prob C §16004(a). Restatement (Third) of Trusts §78, Comment d (2007). National banks are prohibited from these transactions unless certain requirements are met. 12 CFR §9.12(b)(1). Although Prob C §16004(a) refers to "profit," it is unclear whether there has to be an actual profit for a violation to have occurred or whether the potential of realizing a profit is sufficient. See *Jorgensen v Beach 'n' Bay Realty* (1981) 125 CA3d 155, 162, 177 CR 882 (direct profit to agent/fiduciary not necessary). In *Estate of Martin* (1999) 72 CA4th 1438, 86 CR2d 37, for example, the court voided redemption of an estate's stock because the executor failed to disclose that she owned stock in the same company.

Because the issue of profit to the trustee is unclear, any transaction between the trust and trustee should be entered into only if the instrument authorizes the transaction or if the potential for conflict is removed by obtaining the informed consent of the beneficiaries (Prob C §16463) or, ideally, court approval. After the fact, release (Prob C §16464) and affirmance (Prob C §16465) are available. See §2.39 on curing conflicts. The trustee should be particularly wary of transactions concerning trust property that does not have a readily ascertainable value, such as real property or jewelry, because the law presumes that a trustee should avoid participating in any transaction "where his duty is to be performed under … serious temptation." *Broder v Conklin* (1898) 121 C 282, 285, 53 P 699. The prohibition extends to all sales and purchases, regardless of whether the value of the assets in question is set by an impartial third authority. Moreover, a literal reading of Prob C §16004(a) would prohibit even transactions in which there was a readily ascertainable value set by an independent third party.

The same prohibition applies in leasing situations. A trustee leasing for personal use property belonging to the trust is violating the self-dealing statutes, even if fair market value is paid for the property. See Prob C §16004(a). Corporate trustees run afoul of the prohibition against self-dealing if trust real property is leased to the corporation for corporate offices. The trustee's attorney should discuss the importance of avoiding self-dealing with the trustee at the time the trust is implemented to avoid these types of problems.

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§2.24 (2) Sale or Lease of Trustee's Assets to Trust

A trustee who sells or leases personal assets to the trust breaches his or her fiduciary duty against self-dealing. Prob C §16004(a); Restatement (Third) of Trusts §78, Comment d (2007). This prohibition means that the trustee cannot sell assets from his or her portfolio directly to the trust, even if their acquisition would be appropriate for the trust, nor can the trustee lease real property to the trust or to a business owned by the trust. The rationale is that the trustee could profit from the sale or lease by preferring his or her own interests over those of the trust beneficiaries in the negotiation. Like the prohibition against sale of assets to the trustee (see §2.23), the statutory prohibition against the trustee's sale or lease of property to the trust applies whether or not the assets have a readily ascertainable value.

A problem arises when the trustee individually owns a joint interest in property with the trust and wishes to sell his or her half to the trust or to buy the trust's half and consolidate the holdings. This situation most commonly occurs when the surviving spouse is trustee and the residential real property is split between the trust and the spouse. Even this situation falls under the general rule that sale or purchase between the trust and trustee is a breach of fiduciary duty under Prob C §16004(a). As a practical matter, however, the transaction quite often goes forward in these circumstances with little objection because of harmonious relations between the trustee and beneficiaries. Nevertheless, the trustee's attorney should be particularly alert to situations in which the trust beneficiaries are a spouse from a second marriage and children from a first marriage. Generally, the safest approach would be for the spouse/trustee to petition the court for approval before consummating any sale or exchange of assets held jointly with the trust.

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§2.25 (3) Business Competition With Trust

A trustee is prohibited from conducting a business that competes with the trust. Prob C §16004(a). See also Prob C §16002 (duty of loyalty). The reason for the prohibition is twofold. First, the trustee should not use time and expertise on a competing business effort that should be devoted to trust management. Second, the trustee might be tempted to divert business opportunities from the trust to his or her own business. The prohibition is similar to the corporate opportunity doctrine, which holds that an officer or director of a corporation may not personally engage in a business that competes with that of the corporation. *Industrial Indem. Co. v Golden State Co.* (1953) 117 CA2d 519, 533, 256 P2d 677; *Sequoia Vacuum Sys. v Stransky* (1964) 229 CA2d 281, 40 CR 203. See also Corp C §309 (duty of good faith). Because the strength of the fiduciary relationship between a trustee and trust is as great or greater than the relationship between a corporate director or officer and the corporation, the body of law developed for corporate opportunity should apply by analogy to competition with trust business.

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§2.26 (4) Loans From Trustee

The self-dealing aspect of loans from the trustee to the trust or to a third person dealing with the trust has proven troublesome under California law. Because a trustee is specifically prohibited from using the trust property for personal profit under Prob C §16004(a), a trustee who makes loans to the trust may be in breach of its fiduciary duty because of profits from the interest paid on the loan. However, Prob C §16015 expressly states that a financial institution acting as a trustee may furnish services for compensation "in the ordinary course of business" either to the trust or to a person dealing with the trust, *e.g.,* a purchaser of property from the trust, and that such services do not constitute a breach of Prob C §16004. See §2.28. Under common law, a loan from the trustee to the trust is allowed if necessary for the proper administration of the trust. 3 Scott & Ascher on Trusts §17.2.6 (5th ed 2007). Moreover, loans to the trust by the trustee are expressly permitted by many trust instruments. Trust instrument directions control over general trust law. Prob C §16000.

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§2.27 (a) Protection for Trustee

A trustee who lends funds to the trust when no other lender can be found may nevertheless be open to accusations from the beneficiaries that borrowing was imprudent, *i.e.,* that the unwillingness of other lenders indicated that the trust should not be encumbered with interest payments. Particularly in the family trustee situation, however, the trustee often faces the dilemma of being the only one willing to lend funds to the trust when the need for funds is urgent.

To help protect a trustee who does lend funds to the trust, the trustee's attorney should provide guidelines on how to avoid later liability; the trustee must be able to prove that the terms of the proposed loan are fair to the trust. The best evidence of fairness can be obtained by ascertaining prevailing loan terms from several lenders, including rate of interest, duration, prepayment penalties, and points. The trustee should document this information in the trust records and should state in the records why the loan was necessary and why the trustee, rather than a commercial lender, lent the funds. All loan transactions should be in writing, indicating specific duration, rate of interest, and default provisions. However, given the unsettled state of the law, none of these precautions is guaranteed to eliminate the legal issue of self-dealing. The trustee's best protection against potential liability, therefore, is to petition the court for instructions under Prob C §17200 before making the loan and, if necessary, before repayment.

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§2.28 (b) Loans From Corporate Fiduciary

The loan by a commercial or corporate fiduciary to a third party does not in itself constitute a breach of trust. See Prob C §16015; *Estate of Wemyss* (1975) 49 CA3d 53, 61, 122 CR 134 (court declined to remove corporate executor who had made loan to purchaser of estate's assets; court held that conduct of bank as commercial lender had not been adverse to fiduciary interests it held as trustee for estate). See also *Estate of Pitzer* (1984) 155 CA3d 979, 202 CR 855, which concerned a trustee's loan to the assignee of a purchaser of trust assets. Examining the facts in the case before it, the *Pitzer* court held that a breach of trust had occurred, noting that the bank had made a profit on the loan during the 1-year escrow and had also violated former CC §2229 by taking a deed of trust on the trust property, because if the borrower defaulted on the loan the bank would obtain trust property at a fraction of its value.

NOTE: The Law Revision Commission Comment to Prob C §16015 states that this section is intended to be consistent with the rule stated in *Pitzer.* In light of *Pitzer*, it is difficult to imagine that a court would not find a breach of trust when a commercial bank makes a loan to a third party to purchase trust property that is secured by that same property. There is even more reason to believe that the court would find a breach when any interest-bearing loan is made by the bank to a trust for which it acts as trustee. Therefore, unless the transaction is specifically authorized by the trust instrument, the safest approach is to obtain court approval. The corporate trustee of a revocable trust may consider asking the settlor to amend the trust instrument to specifically authorize the transaction and/or obtain the settlor's written direction and informed written consent. See Prob C §§16001(a), 16462(a), 16463. Obtaining consents may not be an option with an irrevocable trust due to the existence of minor, unborn, and unascertained beneficiaries.

Title 12 CFR §9.12(c) states that national banks may make loans to trusts of which they are trustees if the transaction is fair to the trust and there is no prohibition under applicable law (defined in 12 CFR §9.2(b) to include state and federal law, terms of the governing instrument, and court orders). California law authorizes these transactions for state-chartered banks. Fin C §786. The statute has not been cited in any reported decision. Despite its wording, it is unclear whether §786, with its specific but limited application, when taken together with *Wemyss*, will be held to override the general statutory prohibition in Prob C §16004(a) against self-dealing.

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§2.29 (c) Problem of Defaulting Trustee

Default of a loan made by a trustee to the trust presents another potential self-dealing situation because the trustee necessarily assumes the position of both borrower and creditor. If the trust cannot repay the loan from earnings, the trustee must decide how best to recover principal and accumulated interest. One option is to avoid default by "renegotiating" the terms of the loan—something of a misnomer because the trustee is on both sides of the transaction. Unless there is real hope that the financial status of the trust will improve to permit repayment, the trustee who "renegotiates" may simply be putting off an inevitable default problem until a later date, meanwhile allowing more interest charges to be incurred by the trust. Another option to consider depends on whether the loan is secured. If it is, the trustee can liquidate the assets pledged for security. If it is not secured, the trustee must choose trust assets to be liquidated. To avoid criticism from the beneficiaries, the trustee should consult counsel before liquidating any assets to repay the loan. Counsel may suggest petitioning the court for instructions to protect the trustee from later liability. See §15.26. Some trustees, particularly family members, might be willing to forgive a loan to the trust, but, even if they do, they should consult their attorney for advice concerning the possibility of adverse tax consequences.

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§2.30 (5) Loans From Trust to Trustee

The trust in most cases should not lend trust funds to the trustee for personal use. Such a loan would be for a purpose "unconnected with the trust" and accordingly would constitute a conflict of interest under Prob C §16004(a). The only circumstances under which a loan from the trust to its trustee might be held proper is when the trustee can demonstrate that the loan was a prudent investment for the trust and there was no better use of the funds. *Manchester Band of Pomo Indians, Inc. v U.S.* (ND Cal 1973) 363 F Supp 1238, 1245, citing Restatement (Second) of Trusts §170(1) (1959) (if trust instrument permits loan to trustee, trustee must still act in good faith). Obviously, such a demonstration would be rather difficult insofar as the loan would pay only interest while diminishing the growth of principal, so the trustee should be particularly careful in this regard. See Restatement (Third) of Trusts §78, Comment c(2) (2007).

It is unlawful for a national bank to lend funds held in a trust to any director, officer, or employee of the bank, and fines and imprisonment, or both, may be imposed for a violation. 12 USC §92a(h). Limited exceptions are provided by the Comptroller of the Currency under 12 CFR §9.12(b).

Loans from the trust to trustee should be in writing and all the terms specifically stated. See, *e.g., Estate of Tierney* (1945) 68 CA2d 621, 157 P2d 411. In addition, the trustee would be well advised to seek court approval by a petition for instructions under Prob C §17200(b)(6) for additional protection because this type of transaction is basically suspect.

A trustee may not pledge trust assets for a loan to himself or herself or to a closely held company in which the trustee holds an interest, regardless of good faith. *People v Larkin* (ND Cal 1976) 413 F Supp 978 (court specifically found trustee in violation of former CC §2229 (now Prob C §16004(a)).

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§2.31 (6) Other Services

Although a trustee is entitled to reimbursement for out-of-pocket payment for services performed by others to aid in the administration of the trust (Prob C §15684), under common law a trustee who personally performed these same services and charged the trust a fee other than fees for acting as fiduciary was usually guilty of self-dealing. Restatement (Second) of Trusts §170, Comment o (1959); 3 Scott & Ascher on Trusts §17.2.8 (5th ed 2007). See also Restatement (Third) of Trusts §78, Comment c(5) (2007).

In California, the "*Parker* rule" (*Estate of Parker* (1926) 200 C 132, 251 P 907) has been applied primarily to prohibit executors, trustees, or administrators from being paid for legal services rendered to the estate. The public policy reasons are that a fiduciary should not be his or her own employer and that without such a rule the attorney-fiduciaries would be tempted to defraud the trust or estate. But see *Estate of Lankershim* (1936) 6 C2d 568, 58 P2d 1282. This common law prohibition is designed to discourage the fiduciary from performing unnecessary services at high rates of compensation, and it applies regardless of the value of the work the trustee performs, the fact that the trustee could have lawfully hired an agent for those services, or whether the rates charged by the trustee are competitive. Probate Code §15687 constitutes a statutory limitation on compensation for an attorney who serves as trustee and establishes a procedure to seek authority for dual compensation. See chap 9 for discussion of the procedure prescribed by Prob C §15687.

There is case law distinguishing the line of attorney-executor cases from those in which executors have charged additional compensation for accounting services and the latter charge has been held permissible. See *Estate of Haviside* (1980) 102 CA3d 365, 162 CR 393. *Haviside,* however, relied exclusively on an interpretation of the language of former Prob C §902, and its rationale cannot be relied on in a trust context. There is only one case in which the court allowed a trustee to receive compensation as officer of a corporation held in the trust of which he was trustee, holding that the services were necessary and no more than proper, and citing Restatement (Second) of Trusts §170, Comment n (1959). *Estate of McLaughlin* (1954) 43 C2d 462, 470, 274 P2d 868. For further discussion, see chap 9.

Probate Code §16247 expressly permits a trustee to hire accountants, attorneys, auditors, investment advisers, or other agents to advise or assist the trustee in the performance of administrative duties, even if they are associated or affiliated with the trustee. An agent with a close relationship with the trustee or an insider may be hired when it is in the best interests of the trust, taking into account the duty of loyalty and the duty to avoid conflicts of interest, and particularly with respect to routine matters. In situations involving substantial matters, however, it is best to hire outside agents. See Comment to Prob C §16247.

An account furnished under Prob C §16062 must name the agents hired by the trustee, their relationship, if any, to the trustee, and their compensation for the last complete fiscal year of the trust or since the last account. Prob C §16063(a)(4).

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§2.32 (7) Disqualified Persons As Trustee

Probate Code §15642(b)(6) was enacted to avoid abuses and conflicts of interests inherent when a settlor of a trust appoints as trustee a "disqualified person" as described under Prob C §21350(a). Attorneys who draft the trust instrument fall within the definition of disqualified persons and should avoid the temptation of recommending themselves or their firms' services as trustees unless the heightened standards of independent review are met.

An appointed trustee who falls within the definitions of a disqualified person will be automatically removed from office unless a court makes certain findings. The disqualified person may continue to serve as trustee only if a court finds that the appointment was consistent with the settlor's intent and not the product of fraud, menace, duress, or undue influence. The burden of proof rests on the appointed trustee to show that such appointment is appropriate and the result of an exercise of free will by the settlor. On removal of a trustee, see §§4.19-4.37.

A person who otherwise meets the definition of a disqualified person may nonetheless serve as trustee if:

- The settlor is related by blood or marriage to, or cohabited with, the trustee, the person who drafted the trust, or the person who caused it to be transcribed (Prob C §15642(b)(6)(A));
- The trust instrument is independently reviewed and certified by legal counsel (Prob C §15642(b)(6)(B)); or
- After the relationships of the persons involved have been fully disclosed, the instrument is approved by a court order under the substituted judgment provisions of the Probate Code (Prob C §15642(b)(6)(C)).

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.33 (8) Special Problems of Corporate Trustees; the 'Wall' Concept

§2.33 (8) Special Problems of Corporate Trustees; the "Wall" Concept

Some self-dealing situations are unique to corporate fiduciaries. For national banks, self-dealing situations are governed by 12 CFR §9.12, which essentially prohibits all types of transactions between the trust and trustee unless one of the enumerated exceptions applies. The prohibition extends to the trustee's directors, officers, employees, affiliates, and subsidiaries. 12 CFR §9.12.

Because instances of self-dealing can occur without the trust department's knowledge, many corporate fiduciaries have attempted to develop procedures to segregate their trust functions from other bank functions. These procedures, varying in scope from institution to institution, are sometimes called the "Wall" separating the trust and commercial sides of the bank. The Wall is a concept recognized only in the area of securities laws. Its original function was to prevent SEC Rule 10b-5 (17 CFR §240.10b-5) violations by regulating the flow of information between the trust and commercial sides of the bank. Rule 10b-5 prohibits the use of insider information when other areas of the same institution are buying and selling securities.

Communication is prohibited between the commercial and trust sides of a bank concerning the dissemination of inside information under SEC Rule 10b-5. While the Comptroller of the Currency does not require a strict separation of the trust and commercial sides of the bank, it does require all national banks to have written policies and procedures in place to ensure compliance with federal securities laws in connection with the decision to purchase or sell securities. See 12 CFR §9.5(b). The Securities and Exchange Commission has recognized the validity of the Wall arrangement.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/ (a) Securities Transactions/§2.34 (i) Purchase of Securities of Trustee

(a) Securities Transactions

§2.34 (i) Purchase of Securities of Trustee

The purchase of securities of the trustee is prohibited unless the instrument provides specific authority or the purchase is authorized by other means such as consent of all beneficiaries or court order. Prob C §16004(a); *Copley v Copley* (1981) 126 CA3d 248, 178 CR 842. See §2.39. National banks serving as trustees are expressly forbidden to purchase their own securities, including acquisitions through exchanges or debt retirements, unless authorized by applicable law (defined in 12 CFR §9.2(b) to include state and federal law, terms of the governing instrument, and court orders). See 12 CFR §9.12(a).

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§2.35 (ii) Retention of Corporate Trustee's Own Stock

Often, a trust at its inception holds securities of the corporate trustee, or a corporate trustee takes over as successor trustee of a trust holding some of its shares acquired by the prior trustee. Retention of its own securities by the corporate trustee can be classified as self-dealing because the trustee profits from having a market for its shares. However, Prob C §16220 provides that trust property received from a settlor or other person may be retained even though it includes property in which the trustee is personally interested. Even if the trust instrument provides general authorization for the retention of existing assets, it may be helpful to have specific authorization to permit a corporate trustee to retain its own securities. Specific language gives the trustee greater protection than the standard boilerplate retention language found in most trust instruments. Presumably the rule that the language of the trust controls should apply. See Prob C §16000; *Copley v Copley* (1981) 126 CA3d 248, 178 CR 842. National banks are authorized by the Comptroller of the Currency to retain their own securities if authorized to do so by applicable law (defined in 12 CFR §9.2(b) to include state and federal law, terms of the governing instrument, and court orders). See 12 CFR §9.12(a).

Many corporate trustees have a policy of liquidating their own securities unless divestment would cause hardship to the trust, as might be the case when the securities have a low basis.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.36 (iii) Voting of Trustee Securities

§2.36 (iii) Voting of Trustee Securities

A corporate trustee is restricted from voting its shares held in trusts that it administers, except to the extent that the settlor or beneficial owner possesses and exercises a right to vote or gives the trustee binding instructions on how to vote such shares. If there are one or more cotrustees who are not restricted from voting, the shares may be voted by the cotrustees as if it or they are the sole trustee. Corp C §703(c).

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§2.37 (b) Deposits in the Corporate Trustee's Banking Department

Probate Code §16225(b) allows deposits in the corporate trustee's banking department, and overrides the general self-dealing prohibition in Prob C §16004(a). The Comptroller of the Currency has authorized national banks that are trustees to place funds awaiting investment in either the commercial, savings, or other departments of the bank unless prohibited by applicable law (defined in 12 CFR §9.2(b) to include state and federal law, terms of the governing instrument, and court orders). 12 CFR §9.10(b). This regulation requires that the trustee bank first set aside United States bonds or readily marketable securities as collateral for trust deposits exceeding FDIC insurance limits. This requirement of collateral security is also contained in Prob C §16225 and Fin C §1562.

Deposit of fiduciary funds in the corporate trustee's banking department presents a possibility for self-dealing because the trustee bank benefits from these funds by lending them to others. Such deposits include all types of insured interest-bearing accounts, such as ordinary passbook savings, certificates of deposit, NOW accounts, money market accounts, and treasury bill accounts. The ability of a bank to place funds in its own deposits does not mean that the corporate trustee can place the assets with itself without further thought. The trustee must be able to show that the self-deposit was at a reasonable rate of interest and was otherwise reasonable and prudent under the circumstances. Prob C §16225(a); *Conservatorship of Pelton* (1982) 132 CA3d 496, 183 CR 188. See §5.38.

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§2.38 b. Problems of Multiple Trusteeships

Often the trustee acts as a fiduciary for more than one trust. When these trusts have competing interests, the trustee is forced into a position that compromises the fiduciary duty owed to the beneficiaries because he or she cannot act in the best interests of both trusts. Prob C §16005 (trustee of one trust has a duty not to knowingly become trustee of another trust adverse to the interest of the beneficiary of the first trust, and a duty to eliminate the conflict or else resign when the conflict is discovered). Such conflict of interest can arise in many different situations. For example, without express authorization in the respective instruments of two different trusts, each of which owns vineyards in Napa Valley, Prob C §16005 could prevent a trustee from acting for both because the two businesses compete with each other.

When the trustee acts as fiduciary for more than one trust, fair allocation of investment opportunity can be a problem if both trusts have the same investment goals. An asset that is a suitable investment for all the trusts and is readily available in large quantities (such as securities listed on a national exchange) presents no problem; but a multiple-trust trustee will have a problem fairly allocating investment opportunities for assets that are unique (such as land) or scarce (such as a new issue of securities) if that asset would be a desirable investment for all or some of the trusts being administered. A fair decision must then be made as to which trust, if any, will acquire the asset. The trustee should devise a system for fairly allocating investment opportunities, perhaps on a rotating basis, and document the system in the trust files. Fairness is also a problem when a trustee of multiple trusts believes that a security held by these trusts should be disposed of because it has become an imprudent investment but the trustee knows that a sale of all the trusts' shares might affect the market. Prorata sales in all the trusts have been suggested as a possible solution. 3 Scott & Ascher on Trusts §17.2.15 (5th ed 2007).

Another problem arises when two trusts administered by the same fiduciary transact business with each other, as when one trust buys property from another. This occurs, for example, when a surviving spouse is trustee of both the marital trust and the bypass trust and wants to swap assets between the trusts. Probate Code §16002(b) permits sales or exchanges of property between trusts only if the transaction is "fair and reasonable" to the beneficiaries of both trusts, and the trustee notifies the beneficiaries of both trusts of all material facts relating to the sale or exchange. See also Restatement (Second) of Trusts §170(1), Comment r (1959). But see 3 Scott & Ascher §17.2.15, which indicates that such transactions are generally not voidable, so long as they are fair to both sets of beneficiaries, citing Uniform Trust Code §802(h)(3). Although not required, it is good practice before proceeding to obtain from all beneficiaries their written agreement that the transaction is fair and reasonable. Transactions between trusts are authorized for national banks if the transaction is fair to both accounts and is not prohibited by applicable law (defined in 12 CFR §9.2(b) to include state and federal law, terms of the governing instrument, and court orders). 12 CFR §9.12(d). However, it may be difficult to prove fairness if the transaction involves assets that do not have a readily ascertainable value. In this case, the trustee should consider obtaining several independent appraisals for determining value and should clearly document this effort in the trust records to be able to show later that the sale and purchase was in the best interests of each trust.

When the trustee cannot fairly represent each trust in a transaction that must be made by one of them, the trustee should petition the court for instructions. See chap 15.

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2. Curing Conflicts of Interest

§2.39 a. Possible Methods

It is important to avoid conflicts because by definition they are presumed to be a violation of the trustee's fiduciary duties. Prob C §16004(c). Nevertheless, not all conflicts of interest result in trustee liability; a variety of methods can be used to "cure" them.

The easiest way to cure a conflict is to obtain the consent of the settlor of a revocable trust (Prob C §16462) or of all the beneficiaries (Prob C §16463) before undertaking a questionable transaction. See also *Crenshaw v Roy C. Seely Co.* (1933) 129 CA 627, 19 P2d 50; *Broder v Conklin* (1898) 121 C 282, 53 P 699. Note, however, that a notice of proposed action under Prob C §§16500-16504, applicable to the exercise of the trustee's powers, cannot be used to cure certain specified conflicts of interest or acts of self-dealing. Prob C §16501(d).

Consent of the settlor or beneficiaries requires full disclosure of all the material facts and circumstances surrounding a particular transaction, including the trustee's interest (Prob C §16463(b)(2)), and must not have been induced by improper conduct of the trustee (Prob C §16463(b)(3)). Obviously, the disclosure and consents should be in writing. If the trustee is being represented by the family counsel, the attorney should tell the beneficiaries that he or she is representing the trustee and that they may want independent counsel. Consent will be effective only if the transaction in which the trustee has an adverse interest is otherwise fair and reasonable. Prob C §16463(c). Only the settlor of a revocable trust need consent if the settlor is competent because he or she is the only interested party. Prob C §§15800, 15801, 16462.

If the trustee entered into a transaction with a potential for conflict of interest without having obtained consents or court approval, he or she may seek a release (Prob C §16464) or affirmance (Prob C §16465) for the transaction. For a release or affirmance to be effective, the transaction must in fact be fair and reasonable. Prob C §§16464(b)(4), 16465(b)(4). A release or affirmance is obtained in the same way that consent is obtained. The trustee should get retroactive written approval for the specific actions from those beneficiaries able to provide it and then petition the court for approval if necessary.

Express authorization in the instrument permitting an action that otherwise might constitute a conflict of interest may protect the trustee from liability. Prob C §16461 (exculpation of trustee). This will not be effective, however, to relieve the trustee of liability for a breach of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the interests of the beneficiaries, or for any profit that the trustee derives from the breach. Prob C §16461(b).

Trustees nominated to positions of potential conflict should consider the risks of removal and liability, because the court will examine the circumstances of each transaction for breach of the duty of loyalty and good faith. See *Getty v Getty* (1988) 205 CA3d 134, 252 CR 342 (court approved appointment of "trustee ad litem" to conduct litigation on behalf of trust in place of trustee with conflict). But see Restatement (Third) of Trusts §37, Comment f (2003):

> Ordinarily, a court will not remove a trustee named by the settlor upon a ground that was known to the settlor at the time the trustee was designated, even though a court would not itself have appointed that person as trustee.

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§2.40 b. Obtaining Consent of Unascertainable, Minor, or Incapacitated Beneficiary

As a practical matter, all beneficiaries of an irrevocable trust should consent. See Restatement (Third) of Trusts §74, Comment g (2007); Restatement (Second) of Trusts §216, Comments g-h (1959). For such consent, all beneficiaries must have full capacity to contract and, therefore, cannot be minors. Prob C §16463(b)(1); *Bauer v American Trust Co.* (1936) 17 CA2d 426, 62 P2d 150. A conservator and the court may give consent for a beneficiary who is incapacitated under the doctrine of substituted judgment. Prob C §§2580-2586. See California Conservatorship Practice §§14.7-14.15 (Cal CEB 2005) (conservator has a conflict of interest) and Conserv Prac, chap 18 (substituted judgment). Clearly, because most irrevocable trusts have unascertainable, contingent, or unborn beneficiaries whose consent is impossible to obtain, the beneficiary-consent solution is rarely a feasible means of curing a conflict of interest. Even a beneficiary who has a power of appointment effective at death will not be able to give effective consent because there will always be takers in default.

If there are unascertainable, minor, or incapacitated beneficiaries, the trustee should apply to the court for effective consent by filing a petition for instructions under Prob C §17200(b)(6). See chap 15. The court may appoint a guardian ad litem to represent such beneficiaries. See §§15.16-15.21.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.40A 3. No Relief of Liability for Required Distributions

§2.40A 3. No Relief of Liability for Required Distributions

The trustee may not require a beneficiary to relieve the trustee of liability as a condition for making a distribution or payment to, or for the benefit of, the beneficiary that is required by the trust instrument. Prob C §16004.5(a).

This prohibition does not affect the trustee's right to (Prob C §16004.5(b)):

- Maintain a reserve for reasonably anticipated expenses;
- Seek a voluntary release or discharge of liability from the beneficiary;
- Require indemnification against a third party claim that may reasonably arise as a result of the distribution;
- Withhold any portion of an otherwise required distribution that is reasonably in dispute; or
- Seek court or beneficiary approval of an accounting.

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§2.41 G. Duty of Impartiality

A primary duty of the trustee is to treat the beneficiaries impartially. Simply stated, the trustee must treat all beneficiaries fairly in relation to each other, both individually and by class. See Restatement (Third) of Trusts §§79, 90 (2007). See also 3, 4 Scott & Ascher on Trusts §§17.2.15, 20.1 (5th ed 2007). This common law duty of impartiality was previously acknowledged in case law. *Estate of Bissinger* (1963) 212 CA2d 831, 28 CR 217; see also *Bowles v Superior Court* (1955) 44 C2d 574, 588, 283 P2d 704. It is now codified in Prob C §16003. *Penny v Wilson* (2004) 123 CA4th 596, 20 CR3d 212 (violation of §16003 duty of impartiality and abuse of discretionary power rendered acts of trustee nonbinding).

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§2.42 1. Modification by Language in Trust Instrument

Because the trust instrument ultimately controls the trustee's actions (Prob C §16000; Restatement (Third) of Trusts §70 (2007)), a trustee's duty of impartiality may be modified by specific language written into the instrument by the settlor. Such language may be mandatory, directing the trustee to favor specific beneficiaries or classes of beneficiaries, or may be precatory, merely asking the trustee to consider the needs of one beneficiary first. See *Estate of Colyear* (1970) 10 CA3d 670, 677, 89 CR 147 (testator may insert clause stating that, in case of doubt, rights of either life tenants or remaindermen are to be paramount). See also California Will Drafting §§21.18-21.20 (3d ed Cal CEB 1992) on discretionary payments of income favoring a particular beneficiary. Many trusts, for example, favor the income beneficiary, *e.g.*, the surviving spouse. Another common modification of the duty of impartiality is effected when the trust instrument provides that the trustee must consider the interests of minor children to be of primary importance. Also, the trust may direct that property producing little or no income be retained, a provision that will favor the remainder beneficiaries.

The trustee must first determine the identity of any beneficiaries given preference in the instrument. This is easy to do if the beneficiary is a named or obvious individual, *e.g.,* "my daughter Jane" or "my surviving spouse." If the preference is given to a class of beneficiaries, *e.g.,* minor children or remainder beneficiaries who are direct descendants, the trustee must determine which individuals fit within the class. The trustee must also determine what conditions affect this preference, *e.g.,* age or income limitations. For example, the trust instrument may direct the trustee to give preference to a surviving spouse only while he or she remains unmarried or only while his or her income is less than $20,000 per year.

Clauses that provide for mandatory or preferential retention of assets can also affect the trustee's "impartiality" mandate if the retention will benefit one beneficiary or class of beneficiaries to the detriment of others. Accordingly, the trustee must determine whether the general duty of impartiality requires that balanced investments be made to offset the advantage given a beneficiary by the retention of assets or whether the retained assets are excluded from consideration in investment decisions. See §5.27 on retention of assets.

There are two general contexts in which problems of impartiality confront the trustee: avoiding favoritism for particular beneficiaries (see §2.43) and balancing the conflicting interests between classes of beneficiaries (see §§2.44-2.48).

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2. Problems in Exercising Impartiality

§2.43 a. Trustee's Personal Relationships; Avoiding Favoritism

Impartiality problems arising from a trustee's relationship to individual beneficiaries take many forms, depending on circumstances. It is common, for example, for a trustee to feel closer to one particular beneficiary, especially a relative or someone with whom the trustee has a close personal friendship or a professional relationship outside of the trust connection. When such relationships exist, the trustee must avoid acting in ways that would indicate favoritism. See *Penny v Wilson* (2004) 123 CA4th 596, 20 CR3d 212 (duty of impartiality required trustee to use current appreciated asset values instead of date-of-death values when making delayed division of assets and funding survivor's trust and decedent's trust 16 years after death of first settlor).

A trustee's impartiality can be suspect, *e.g.,* when an individual trustee is also the attorney retained to handle one beneficiary's real property development business, or when a corporate trustee has substantial banking relationships with one beneficiary. Some trustees are even in business with one or more beneficiaries. When these relationships exist, the trustee's duty of impartiality is coextensive with the duty of loyalty and its attendant caveats against conflict of interest. See §§2.21-2.40A.

Often, a trustee's duty of impartiality is put to the test because of sympathy with the plight of an individual beneficiary, *e.g.,* when an income beneficiary is extremely poor and has no power to invade the principal. For example, unless it is specifically permitted under the instrument, manipulating the investment portfolio or misusing the Prob C §16336 adjustment power to favor the income beneficiary or exercising discretion to charge all expenses to principal may violate the duty of impartiality.

Just as the trustee must strive not to exhibit favoritism for particular beneficiaries, so he or she must be careful not to discriminate against others. Often, a trustee disapproves of a beneficiary's unconventional lifestyle, *e.g.,* living in a commune or being a member of a religious cult. Personal disapproval should not affect the trustee's duty of impartiality toward such beneficiaries.

Individual trustees may occasionally resent beneficiaries selected by the settlor, particularly when a charitable remainder beneficiary is chosen instead of family members. But here too the trustee must remain objective and exhibit impartiality in all trust decisions.

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b. Competing Interests Among Beneficiaries

(1) Making Investment Decisions

§2.44 (a) Income Versus Remainder Beneficiaries

The trustee must balance the interests of the income and the remainder beneficiaries when making investment decisions. Restatement (Third) of Trusts §79 (2007). When a beneficiary receives the income during his or her life and on the beneficiary's death the principal is paid to other beneficiaries,

> the trustee has a duty to exercise care to ensure that a reasonable amount of income will be payable to the income beneficiary. But the trustee is also under a duty to the remainder beneficiaries to exercise reasonable care in an effort to preserve the trust property, a duty that ordinarily includes a goal of protecting the property's purchasing power. In some trust situations, the trustee may even invest with a goal of increasing the real value of the principal.… Thus, the duty and balancing are affected by the purposes, terms, distribution requirements, and other circumstances of the trust.

Restatement §79, Comment g.

Further, in making investments, a trustee must consider the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) and the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). See chap 8. For example, the allocation of a trust portfolio between equity and fixed-income investments may vary depending on whether the trustee has the power to make an adjustment between principal and income or convert the trust to a unitrust. No matter how the portfolio is allocated, the UPIA generally requires the trustee to diversify investments. Prob C §16048. See *Wood v U.S. Bank* (Ohio App 2005) 828 NE2d 1072 (general power to retain investments does not override duty to diversify). See also Restatement §79, Comment d. This rule applies in California under Prob C §16202, which, consistent with Uniform Trust Code §815(b), provides that "the grant of a power to a trustee, whether by the trust instrument, by statute, or by the court, does not in itself require or permit the exercise of the power." But see *Americans for the Arts v Ruth Lilly Charitable Remainder Trust* (Ind App 2006) 855 NE2d 592 (trustee did not have duty to diversify trusts assets because trust document expressly conferred power to retain indefinitely corporate stock received by trustee). See also *In re Stuart Cochran Irrevocable Trust* (Ind App 2009) 901 NE2d 1128 (trustee did not act imprudently when it surrendered the trust's life insurance policies, which might have lapsed within a period of time shorter than the settlor's life expectancy, and acquired a new policy that provided a much lower death benefit guaranteed to age 100).

The problems the trustee faces in trying to balance competing interests of income and remainder beneficiaries were addressed by the court in *Estate of Bissinger* (1963) 212 CA2d 831, 28 CR 217. In this case, a remainder beneficiary objected to a sale of low-income-producing stocks made in order to buy bonds producing a higher and more regular amount of income for the income beneficiary, but the income beneficiary objected that not enough of the stocks were sold to produce an adequate income. The court found that the trustee had acted prudently in selling part of the stock. In *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473, the court held that the trustees of a testamentary trust did not violate the duty of impartiality to income beneficiaries by retaining stock that yielded dividends of only 1.25 percent of the stock's value. The court noted that dividends paid to the income beneficiaries had increased greatly as a result of the conservative dividend policy over the preceding 30 years.

When the trust is revocable, or when a beneficiary has a presently exercisable general power of appointment or a power to withdraw the trust assets (Prob C §15803), the trustee must follow a written direction acceptable to the trustee from the settlor or the holder of the power concerning investments that might favor one class of beneficiaries. See Prob C §16001(b) on written directions that modify the terms of a revocable trust. See §16.9.

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§2.45 (b) Investment Decisions and Individual Beneficiary Needs

The varying personal financial situations of multiple income beneficiaries can make it difficult for the trustee to be impartial toward them all. Income beneficiaries are often in different income tax brackets; hence, wholesale investment in assets yielding high taxable income would be unfair to a beneficiary in a high tax bracket, whereas, conversely, investment in all tax-exempt issues would be unfair to a low-tax-bracket beneficiary. Although it is unlikely (and unwise) that the trustee would take all-or-nothing investment positions, there is no easy answer to the real question of how to balance the competing interests to produce a fair and equitable yield for all income beneficiaries. The solution, which must also take into account the remainder interests and all the assets of the trust estate, must be calculated according to the circumstances of all the beneficiaries. The trustee should explore beneficiary needs. The trustee should also consider investing in stocks with low dividend yields regardless of beneficiary needs and using the Prob C §16336 power to adjust between principal and income to allocate investment gains as needed to the income beneficiaries. See §2.48.

The preferences of various remainder beneficiaries may differ, too. An affluent remainder beneficiary who is related to a poor income beneficiary might prefer that the trust be invested for maximum income to benefit the income beneficiary, while another remainder beneficiary in less fortunate financial circumstances might disagree.

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§2.46 (c) Division of Securities on Termination

At termination of the trust, it is usually preferable for the trustee to make a prorata distribution except when all beneficiaries agree otherwise or when spouses have agreed in writing, as permitted under Prob C §16246, to a nonprorata distribution of community property or quasi-community property, or both. As a practical matter, some assets may have better prospects for appreciation or a better stream of income than others. In addition, the trustee may need to take into account the tax basis of the various assets. Accordingly, as a general rule, the trustee should divide each type of asset equally among the beneficiaries. Generally, this procedure is recommended even though the trust instrument and Prob C §16246 allow a nonprorata distribution. For an example of such a clause, see California Will Drafting §31.4 (3d ed Cal CEB 1992). The trustee should avoid, for example, giving one beneficiary all the municipal bonds and another all the high technology stock, and should instead have each asset divided into equal shares. See chap 16. For an additional discussion, see Will Drafting §31.3.

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§2.47 (2) Beneficiary's Use of Assets

Unless the trust instrument specifically permits, a trustee breaches the duty of impartiality by allowing one income beneficiary to use real property without paying rent, unless some offset is arranged. The offset can take one of several forms, as long as the other income beneficiaries are given benefits from the trust of like value. For example, if monthly total trust income of $12,600, including the fair market rental value of the rental property, is to be split equally among three beneficiaries, one of whom uses rent-free trust property whose fair market value is $600 a month, this beneficiary is entitled to cash income of $3600, plus $600 representing the rental value, and the remaining beneficiaries are entitled to $4200 each, representing cash in the amount of $4000 plus $200 representing the amount they would receive from the property had it been rented. If the rental value of trust property used by a beneficiary exceeds his or her share of income, the trustee should consider making the beneficiary pay the difference to the trust or obtaining the consent of all the other income beneficiaries to allow that beneficiary to live partially rent free. Consent to rent-free occupancy might also be sought in other cases even when the beneficiary's income is sufficient to provide the offset.

The trade-off issue arises also when beneficiaries borrow trust assets without adequate security. The borrowing beneficiary could, by virtue of the loan, be enjoying greater use of trust assets than is available to other beneficiaries, who unequally face risk to the corpus if the borrower cannot repay an unsecured loan. In addition, the trust loses income if the interest rate does not equal market rate and there is no possibility of increasing the interest rate. The subject of loans to trust beneficiaries is discussed in §5.90.

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§2.48 (3) Allocation of Receipts and Disbursements

The trustee can disproportionately affect the beneficiaries' interests in the trust by allocation of principal and income receipts and disbursements, *e.g.,* by allocating ambiguous receipts or disbursements to income, thereby increasing or decreasing payments to the income beneficiary. The trustee must look to directions in the instrument that govern the allocation of receipts and disbursements as to principal and income. Prob C §16335(a)(1). Absent such directions, or absent the instrument giving the trustee discretion over the allocation, the trustee must follow the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), which sets forth how receipts and disbursements must or may be allocated between principal and income. However, the UPAIA allows the trustee to adjust between principal and income to the extent needed to comply with the duty of impartiality. Prob C §16336. Thus, the trustee can shift a share of investment gains to income beneficiaries notwithstanding the regular rules for allocating receipts. Alternatively, the trustee may be able to convert the trust to a unitrust paying a fixed percentage of trust assets to the income beneficiaries. Prob C §§16336.4-16336.6. See chap 8. The trustee can address the complexities and issues arising under the UPAIA by using a Notice of Proposed Action under Prob C §§16337, 16500-16504 (similar to the notice of proposed action procedure under the Independent Administration of Estates Act (Prob C §§10400-10592); see §8.9). The trustee should consider seeking the consents or objections from beneficiaries regarding a proposed treatment of an item of principal or income, receipts, or disbursements. Use of this procedure will safeguard the trustee against allegations that he or she acted unfairly toward respective or competing beneficiary interests under the trust instrument.

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II. TRUSTEE'S STANDARD OF CARE

§2.49 A. Measure of Trustee's Duties

The trustee's standard of care is the measure of compliance with the trustee's duties. Probate Code §16040 (discussed in §2.50) deals with the basic standard of care and Prob C §16014 (discussed in §2.51) addresses the question of the "expert" trustee. Section 16040 governs administrative decisions and acts, including maintaining proper trust records, making proper discretionary decisions (such as the amount of disbursements), and safeguarding valuables. Note that the same standard applies whether the trustee receives compensation or not. Prob C §16041.

The trustee's standard of care differs, however, with respect to investments. See Prob C §16047, discussed in §2.52. Probate Code §16042 sets out the standard of care for trust property held by the public guardian or public administrator appointed as trustee of a trust under Prob C §15660.5. See §9.19.

Statutory standards may be expanded or restricted by the terms of the trust instrument (Prob C §16040(b)). The trust instrument may provide for a change in the standard of care which directly effects the trustee's duties. See, *e.g.,* Drafting California Revocable Trusts §§4.44-4.49 (4th ed Cal CEB 2003).

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§2.50 B. California Basic Standard of Care

Except as otherwise provided in the trust instrument, a trustee is required to administer the trust (Prob C §16040(a))

> with reasonable care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument.

This standard of care applies to all trusts, regardless of the date of creation. See Prob C §15001. See also Restatement (Third) of Trusts §77 (2007). But see Prob C §16042 (standard of care for trust property held by the public guardian). It is essentially modeled after the "prudence" rule of the Employee Retirement Income Security Act (ERISA) (29 USC §§1001-1461). See 29 USC §1104(a)(1)(B).

Until 1985, California had a general "prudent man" standard of care based on common law. See former CC §2261(1); Restatement (Second) of Trusts §174 (1959). Former CC §2261(1) required that the trustee exercise "the judgment and care, under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of their own affairs." The current standard of care under Prob C §16040(a) shifts the emphasis from how the trustee would handle personal affairs to how another trustee would act under similar circumstances.

Because of the change in the law, pre-1985 cases and the Restatement (Second) may be of limited usefulness in determining the appropriate standard. Although cases under the ERISA standard would seem to apply, there are few such cases. Further, trusts regulated by ERISA seldom face many of the income tax and other issues common to other trusts.

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§2.51 C. "Expert Trustee" Standard in California

The trustee has a duty to apply the full extent of his or her skills. If the settlor has relied on the trustee's representation of having special skills, the trustee is held to the standard of the skills represented. Prob C §16014.

Probate Code §16014 applies to individuals as well as to corporate trustees. Individuals holding themselves out as having expertise in a specific area may be held to an expert standard in that area but not necessarily in others. For example, an investment counselor acting as a trustee may be held to an expert standard regarding investments such as stocks or bonds but not necessarily held to such a standard for real property management. An attorney-trustee may be held to a higher standard than the trustee with "ordinary skill" with respect to fiduciary duties and taxation of trusts but probably not with respect to investments.

In applying an "expert" standard, it is important to remember that even an "expert" fiduciary is not required to guarantee superior results. Even under the higher standard applied to an expert trustee, the courts require only the "careful consideration" and "proper care and skill" expected of professional-level management. See Restatement (Third) of Trusts §77, Comment a (2007); 3 Scott & Ascher on Trusts §17.6 (5th ed 2007).

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§2.52 D. Prudent Investor Standard of Care

The trustee is held to a different standard concerning investment of trust assets. In exercising his or her investment powers, the trustee must comply with the requirements set forth in the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) unless the instrument otherwise provides. Prob C §16046(b). Probate Code §16047(a) provides that the "trustee shall invest and manage trust assets as a prudent investor would," and further provides that, "[i]n satisfying this standard, the trustee shall exercise reasonable care, skill, and caution." Probate Code §16047(b) requires the trustee to be proactive in adopting an overall investment strategy for the trust and Prob C §16047(c) provides a list of circumstances that the trustee must consider. A trustee is at risk who chooses to ignore the development of an overall investment plan. See chap 5.

NOTE: Advising the trustee to make a proper delegation of investment and management functions under Prob C §16052 should protect him or her from liability in the event the agent's performance results in losses to the trust estate. Compliance with the provisions of Prob C §16052(a), with limited exceptions, is a statutory bar to trustee liability. Prob C §16052(c).

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III. TRUSTEE'S POWERS

A. Powers Necessary to Carry Out Trust Purpose

§2.53 1. Powers Granted by Statute

The trustee must have sufficient powers to ensure that the purposes for which the trust was created can be carried out and to be able to perform the attendant fiduciary duties to the beneficiaries. The Trust Law (Prob C §§16200-16249) gives the trustee broad and detailed powers and, in effect, leaves it to the settlor to restrict the powers if that is intended. Even restrictions on powers can be relaxed by the court. Prob C §16201. The statute comports with case law, which holds that the trustee impliedly has all powers necessary to carry out the purpose of the trust. *Craven v Dominguez Estate Co.* (1925) 72 CA 713, 719, 237 P 821.

The powers described under Prob C §§16220-16249 are granted automatically to the trustee unless limited by the trust instrument. Prob C §16200(b). See *Irvine v MacGregor* (1928) 203 C 583, 265 P 218. For a table of trustee powers, see §2.53A. These powers are exercisable by the trustee even though not specifically granted in the will or trust instrument or incorporated by reference. Prob C §16200(b). See §2.53B. However, Prob C §16202 further provides that the grant of a power to a trustee does not in itself require or permit the exercise of the power, which remains subject to the trustee's overriding fiduciary duties. See Comment to Prob C §16202.

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§2.53A a. Table of Trustee Powers

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Section	*Powers Granted*
§16220	Collect and hold property
§16221	Receive additions to trust
§16222	Operate or participate in a business subject to certain limitations
§16224	Invest in United States government obligations
§16225	Deposit funds at reasonable interest in an insured or collateralized account
§16226	Acquire or dispose of property
§16227	Manage property
§16228	Encumber property
§16229	Make alterations and repairs
§16230	Develop land
§16231	Enter into leases
§16232	Enter into mineral leases
§16233	Grant options, which may extend beyond the term of the trust
§16234	Vote shares or give proxies (see also Corp C §§702(a), 703(c), 704, 705)
§16235	Pay calls and assessments related to securities
§16236	Sell or exercise stock subscriptions and conversions
§16237	Consent to corporate reorganizations and other changes
§16238	Hold securities in name of nominee
§16239	Deposit securities in securities depository
§16240	Insure property
§16241	Borrow money
§16242	Settle and pay claims
§16243	Pay taxes, reasonable compensation of trustee and agents, and other expenses
§16244	Make loans to beneficiaries on terms that are fair and reasonable or guarantee loans
§16245	Distribute property to beneficiaries even if under legal disability
§16246	Distribute in kind and make prorata or nonprorata distributions, and make adjustments
§16247	Employ agents

§16248 Execute and deliver instruments

§16249 Prosecute or defend actions

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§2.53B b. Exercise of Trustee Powers

Although the trustee is acting within the scope of his or her legal authority in exercising the powers granted by statute but not specifically included in the instrument, practical problems of proving the right to do so still remain. Most practitioners choose to enumerate the powers in the instrument (see §2.56) or incorporate the statutory powers by reference (see §2.59) to facilitate dealing with persons not familiar with California law. These include the power to incur debts and enter into contractual obligations. See §§2.55A-2.55G.

In addition to the powers granted in Prob C §§16220-16249, Prob C §§850-859 grant the trustee authority to petition the court for a determination of ownership of real and personal property.

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§2.54 2. Conflicts Between Statutory Powers and Trust Instrument Powers

The express terms of the trust instrument govern the trust's administration. Prob C §16000; *Union Bank & Trust Co. v McColgan* (1948) 84 CA2d 208, 190 P2d 42. (See, however, §16.9 on the effect of directions by the person holding the power to revoke under Prob C §16001.) Therefore, if the powers granted by statute conflict with those in the instrument, the instrument will control unless the court, under Prob C §16201, relieves the trustee from any restriction contained in the trust instrument. See §2.56.

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§2.55 3. Inclusion of Powers in Trust Instrument

Administration will be easiest for the trustee when the trust's governing instrument has specifically conferred all the necessary powers, making it unnecessary to have recourse to statutes, implied powers, or the court.

The trustee's attorney should review the instrument to make sure it contains all necessary powers or that such powers are conferred by statute. If the necessary powers for administering a *revocable* trust are not present in the instrument or conferred by statute, the trustee's attorney should recommend that it be amended to provide them. See Drafting California Revocable Trusts (4th ed Cal CEB 2003). If the powers provided by an *irrevocable* trust instrument or conferred by statute do not seem sufficient, the trustee may petition the court under Prob C §17200(b)(8) for additional powers. Before seeking additional powers, the attorney for the trustee should be sure that the additional powers will not create adverse tax consequences for the trustee or the beneficiaries. See §2.60. For procedure, see §2.61.

A trustee who believes it necessary and in the best interest of the trust to take an action not expressly authorized by the instrument or conferred by statute can sometimes be in a precarious position. The trustee is required to follow the terms of the trust instrument (Prob C §16000), and to exceed the powers conferred could be a breach of fiduciary duty for which the trustee may become liable to the beneficiaries for damages. However, a trustee who, because the instrument and the statutes are silent on certain powers, fails to act to carry out the trust's purposes or to protect the beneficiaries could also incur liability for any adverse consequences resulting from failure to obtain the necessary power to act. See 3 Scott & Ascher on Trusts §16.4.2 (5th ed 2007); Restatement (Third) of Trusts §66, Comment e, Illustration 7 (2001); Restatement (Second) of Trusts §167, Comment g, Illustration 24 (1959). Faced with this dilemma, the trustee could elect not to petition the court for power to take the necessary action but take it unilaterally on the theory that such power was implied in the instrument as being necessary to carry out the purposes of the trust. The trustee's determination that a power is implied, however, is potentially subject to court review, and the trustee may incur liability if the court later finds that the power exercised in taking a particular action was not implied in the instrument. See §2.58 on implied powers. On the trustee's power to incur expenses and debts, see §§2.55A-2.55G.

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§2.55A a. Trustee's Power to Incur Debts

Unless the trust instrument restricts the powers, the trustee has the extensive powers expressly granted under the Trust Law (Prob C §§16200-16409), including the power to

- Acquire property on credit (Prob C §16226);
- Borrow (Prob C §16241);
- Encumber trust property (Prob C §16228); and
- Hire persons (Prob C §16247).

In addition to this express language, the power to incur debt may be inferred from the power to manage trust property (Prob C §16227) and from Prob C §16200(c), which generally gives the trustee the power "to perform any act that a trustee would perform for the purposes of the trust under the standard of care provided in Section 16040." Probate Code §16050 specifically authorizes the trustee to incur costs for purposes of investing trust property.

A trustee who incurs an expense or borrows funds in his or her capacity as trustee for the benefit of the trust creates a debt on behalf of the trust with respect to the seller or lender. The liability, however, is that of the trust and not of the trustee personally as long as the status of the trustee, acting as such, is revealed in the transaction. Prob C §18000(a). See §2.55E.

NOTE: This discussion assumes that the trustee is someone other than the settlor. Usually, the settlor will be the trustee of the trust until the settlor dies or becomes disabled and the settlor will incur debts or borrow funds in his or her own individual capacity. The trust remains liable for these debts because the assets of a revocable trust are subject to the claims of the settlor's creditors. See §10.9.

In the normal course of trust administration, it may be necessary to borrow to pay for repairs to real property; attorney, accountant, or other professional fees; or development of trust property. The powers to incur debt or borrow, like all other powers, are "subject to the trustee's fiduciary duties." Prob C §16202. For a discussion of borrowing funds generally, see chap 5. For a discussion of borrowing by the trust from the trustee individually, see §2.55B. For a discussion of reimbursement of the trustee's attorney fees, see chap 9.

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§2.55B b. Trustee's Advances

An advance of the trustee's own funds is reimbursable if the expenditure was properly incurred within the scope of the trustee's fiduciary duties. Prob C §15684(a). See *Estate of Gartenlaub* (1921) 185 C 648, 198 P 209; *Estate of Spencer* (1936) 18 CA2d 220, 63 P2d 875. Most cases on this topic concern reimbursement of attorney fees. See chap 9. However, a similar analysis should apply to other types of third party payments. See §§2.55C-2.55D.

If it is determined that the particular expenditure was not properly incurred, the trustee is entitled to be repaid only if the expenditure benefited the trust. Prob C §15684(b). See 4 Scott & Ascher on Trusts §22.2 (5th ed 2007).

Expenses such as payments for repairs or maintenance of trust property clearly benefit the trust and are proper expenses. *Ochoa v McCush* (1931) 213 C 426, 2 P2d 357. Debts incurred for services performed by agents should be reimbursable to the trustee, because the trustee has power under Prob C §16243 to employ agents.

PRACTICE TIP: If the trust is a co-owner of real property and the trustee deems an expenditure necessary and the co-owner disagrees, the trustee should petition the court for instructions whether to expend trust funds to protect the entire property. Prob C §17200. If these problems become chronic, the trustee should consider buying the co-owner's interest or selling the trust's interest in the property to the co-owner or to a third party. If the co-owner refuses to do either, the trustee should consider initiating partition proceedings. CCP §§872.210-872.840.

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§2.55C (1) Costs Must Be Reasonable

Charges must be reasonable in relation to the services performed. The trustee is responsible for determining the reasonableness of the charge. See Prob C §16040. Although little authority is available on this issue, if the charges are not reasonable, the trustee may not be entitled to reimbursement of the entire amount of the charge. The local rules of certain probate courts specify parameters within which the court will approve compensation to attorneys.

The trustee should consider seeking instructions under Prob C §17200(b)(6) before engaging the services of attorneys and other professionals, especially if the charges are expected to exceed the local rule limits. See chap 9. Petitions for instructions in advance of acts of trustees are looked on favorably by the courts as a way of resolving any differences among interested parties. See *Estate of Heggstad* (1993) 16 CA4th 943, 951, 20 CR2d 433.

If the trust owns an undivided interest in real property, the trustee should pay only the trust's proportionate share of expenses. See *Bacon v Bacon* (1948) 32 C2d 131, 194 P2d 697 (each owner of an undivided interest must pay his or her proportionate share of expenses); *Jamison v Cotton* (1933) 136 CA 127, 28 P2d 39. See also 12 Witkin, Summary of California Law, *Real Property* §47 (10th ed 2005). A trustee who pays more than the trust's proportionate share is in breach of his or her fiduciary obligations.

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§2.55D (2) Trustee Must Avoid Fiduciary Abuse

As a general rule, the trustee should not contract with the trust for his or her own personal services or those of his or her family, whether or not the services are related to the trust. This is self-dealing, prohibited by Prob C §16004(a). See §§2.37-2.51. If there are extenuating circumstances warranting such involvement, a petition for instructions under Prob C §17200(b)(6) should be filed. A regulated financial institution serving as trustee, however, may retain and compensate its affiliates. Prob C §16015. Furthermore, under Prob C §16247, any trustee, whether or not a financial institution, may hire agents, even if they are "associated or affiliated with the trustee," to advise or assist the trustee in the performance of administrative duties. To avoid the appearance of self-dealing, the trustee should document in writing any decisions for such engagement and should inform the current beneficiaries.

Trusts may hold a form of shared title (*e.g.,* tenancy in common) in real property in various situations, such as with a third party, with a beneficiary, or with the trustee as an individual. Each of these situations creates the potential for breaches by the trustee. A trustee who, in his or her individual capacity, is a co-owner of real property with the trust may not use trust funds to pay expenses relating to his or her own share because that would constitute self-dealing. Prob C §16004. See §2.37. If the co-owner is a third party, the trustee must not spend trust assets for the benefit of the third party. If the co-owner is one of several beneficiaries, expenditures that benefit one or more beneficiaries to the exclusion of others may constitute a breach of the trustee's duty of impartiality. Prob C §16003. See §2.55.

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§2.55E c. Trustee Not Personally Liable on Contract

Generally, a trustee is "not personally liable on a contract properly entered into in the trustee's fiduciary capacity in the course of administration of the trust unless the trustee fails to reveal the trustee's representative capacity or identify the trust in the contract." Prob C §18000(a). For language that makes the necessary disclosures, see §2.55E. For a form of trustee signature for contracts, see §2.55F. Furthermore, a trustee who engages in litigation in the name of the trust is not personally liable for court costs or other charges imposed on a losing party. See *Haskett v The Villas at Desert Falls* (2001) 90 CA4th 864, 108 CR2d 888, in which the court applied Prob C §18001 and held that a successor trustee was not personally liable to defendants for an attorney fee award to them following the dismissal of the trust's contract action, brought by a prior trustee, absent any showing that the successor trustee was personally at fault.

NOTE: The rule regarding trustee liability is different for contracts entered into before July 1, 1987. Under former CC §2267, the trustee was considered a principal and not an agent and thus was held to be personally liable on contracts in the absence of a specific contract exclusion. To avoid personal liability for the trustee, the trustee's fiduciary capacity had to be disclosed in the contract and the contract had to state that the creditor could look only to the trust assets for repayment. *Zimmer Constr. Co. v White* (1935) 8 CA2d 672, 47 P2d 1087. See §15.51.

The trustee may be entitled to reimbursement from the trust assets even if the contract is made in his or her individual capacity if the subject of the contract is a proper trust expense. See Prob C §15684. Nevertheless, it is good practice to disclose fiduciary capacity, to identify the trust in the contract, and to pay expenses directly with trust assets to avoid a creditor's lawsuit if trust assets are insufficient.

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§2.55F (1) Form: Contract Clause Disclosing Fiduciary Status

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It is understood by all parties that _ _[*name of trustee*]**_ _ is entering into this contract only in _ _**[*his/her*]**_ _ capacity as Trustee**

[*Add one of the following alternatives*]

[*Alternative 1: for living trust*]

under that _ _[*Trust Agreement/Declaration of Trust*]**_ _ dated _ _**[*date*]**_ _,**

[*Alternative 2: for testamentary trust*]

under the Will of _ _[*name of deceased settlor of testamentary trust*]**_ _, deceased,**

[*Continue*]

and that _ _[*name of trustee*]**_ _ shall not be _ _**[*individually/corporately*]**_ _ liable under this contract.**

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.55G (2) Form: Trustee Signature Line for Contracts

§2.55G (2) Form: Trustee Signature Line for Contracts

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[*Use one of the following alternatives*]

[*Alternative 1: trustee of living trust*]

_ _[*Name of trustee*]_ _**, as Trustee under that** _ _[*Trust Agreement/Declaration of Trust*]_ _ **dated** _ _[*date*]_ _**.**

[*Alternative 2: trustee of testamentary trust*]

_ _[*Name of trustee*]_ _**, as Trustee under the Will of** _ _[*name of deceased settlor of testamentary trust*]_ _**, deceased.**

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4. Express Powers

§2.56 a. Standard Powers Itemized in Trust Instrument

Generally, the trust instrument grants the trustee itemized powers appropriate for most trusts by standard provisions that the drafter inserts unless the client asks that they be omitted or modified or unless the trust's assets or circumstances require specially drafted trustee powers. Although some would characterize these standard provisions as "boilerplate," they are no less effective than specially drafted powers. They typically include, among other powers, the power to invest (see Uniform Prudent Investor Act (Prob C §§16045-16054)), to sell or retain assets, to vote proxies, to participate in reorganizations, to incur expenses and debts, to compromise claims or defend litigation, and to borrow, encumber, and lease. All of these powers are now expressly given by statute and exist unless they are negated by the settlor. The trust instrument also may include an omnibus clause as discussed in §2.57.

The trustee must follow the terms of the instrument unless the provision is illegal or impossible, or a change in circumstances warrants a court-ordered deviation. See chap 16 on deviation or modification. Examples of standard itemized powers for trusts are found in California Will Drafting, chap 29 (3d ed Cal CEB 1992). See also Drafting California Revocable Trusts, chap 17 (4th ed Cal CEB 2003); Drafting California Irrevocable Trusts, chap 10 (3d ed Cal CEB 1997).

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§2.57 b. Omnibus Clause

An omnibus clause grants the trustee the power to take any action necessary to carry out the purposes of the trust. Its intent is to confer on the trustee powers that could not have been anticipated at the time the trust was drafted but that later become necessary for administration of the trust. There are two types of omnibus clauses. One is inserted in conjunction with, and immediately following, a list of standard powers such as those noted in §2.56. The clause may be worded in such a way as to afford the trustee sufficient flexibility to eliminate the necessity of petitioning the court for an additional power.

Another type of omnibus clause is a grant to the trustee of all the powers that the absolute owner of the trust's property would have, subject to the trustee's fiduciary obligations. This broad grant of power is used instead of (not in addition to) an itemization of standard powers granted to the trustee. A problem could arise, however, when the trustee exercises a "nonstandard" power under the authority of an omnibus clause, *e.g.,* investing in gold futures. Because beneficiaries could later claim that the settlor did not intend to give the trustee such a power, a trustee should refrain from exercising a nonstandard power under an omnibus clause. If it is absolutely essential to do so, the trustee should consider petitioning the court for the additional power if the additional power would not cause any adverse tax consequences. See §§2.60-2.63.

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§2.58 5. Implied Powers

California recognizes the concept of implied trust powers: essentially, a trustee has "all the authority necessary to carry out the objects and purposes of the trust… even though the instrument creating the trust may not directly confer upon him such power." *Craven v Dominguez Estate Co.* (1925) 72 CA 713, 719, 237 P 821; *Church v Church* (1940) 40 CA2d 696, 105 P2d 640. The courts have also held that trustees have those powers implied in the general directions of the trust that are "reasonable and proper means for making it effectual" (*Gilbert v Penfield* (1899) 124 C 234, 238, 56 P 1107) and that this principle does not conflict with either former CC §2258 (duty to follow all the directions of the trustor) or §2267 (authority is limited to that conferred by the trust) (*Botsford v Haskins* (1978) 81 CA3d 780, 788, 146 CR 752). See also Prob C §16200(c).

Although the concept of implied powers is an accepted part of the law, it is difficult to apply to a given situation. For example, although the court in *Purdy v Bank of America* (1935) 2 C2d 298, 40 P2d 481, found that the power to borrow was implied as necessarily incident to the power to manage and conduct the property, it nonetheless cautioned that the power to borrow (now expressly conferred by Prob C §16241) was "one of the most dangerous powers which may be conferred upon an agent, and the courts are slow to find that such a power may be implied." 2 C2d at 304.

The determination of whether a power that the trustee must exercise is implied depends on the facts, especially the intent of the settlor to the extent it can be ascertained. Because a trustee may incur great liability for exercising a power he or she is found not to have, the trustee's attorney should advise against relying on implied powers. Instead, the trustee should consider petitioning the court under Prob C §17200(b)(8) to obtain powers not stated in the instrument or conferred by statute. See §§2.60-2.63.

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§2.59 6. Statutory Powers Incorporated by Reference

Because Prob C §16200(b) gives the trustee extensive statutory powers, it is not necessary to incorporate these powers (set forth in Prob C §§16220-16249) by reference in the instrument nor to petition the court for authority to exercise them. See Comment to Prob C §16200. Most practitioners continue to include powers expressly or to incorporate them by reference in order to facilitate working with out-of-state transfer agents, for example, who do not know California law.

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7. Notice of Proposed Action

§2.59A a. When Notice May Be Used

As an additional precaution, a trustee may wish to consider sending a notice of proposed action to give beneficiaries an opportunity to object before the trustee takes, or does not take, a particular action. Probate Code §§16500-16504 provide a notice of proposed action procedure for trusts, which is similar to the notice of proposed action procedure for estates under the Independent Administration of Estates Act (see Prob C §§10582, 10585-10587). See §2.59B.

The notice procedure is available for actions governed by Prob C §§16200-16249 (regarding trustee powers) or by the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) and is optional. Prob C §§16500, 16504. The procedure cannot, however, be used in connection with certain actions, such as payment of trustee compensation, settlement of the trustee's accounts, compromise or settlement of claims by or against the trustee, or other specified transactions between the trust and the trustee or the attorney for the trustee. Prob C §16501(d). Examples of actions for which the procedure is useful include selling real property, changing investment accounts, and making tax code elections regarding principal and interest. See §§7.35, 8.9 for discussion of notice of proposed action for matters governed by UPAIA.

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§2.59B b. Notice Procedure

A trustee who elects to use the procedure must send the notice to all beneficiaries who are receiving, or are entitled to receive, income, including those entitled to receive income at the trustee's discretion, or who would receive a distribution of principal if the trust were to terminate at the time the notice is given. Prob C §16501(a). Notice need not be given to a beneficiary who consents in writing to the proposed action, or to any beneficiary who is unknown to the trustee or who is known but cannot be located after reasonable diligence. Prob C §16501(b)-(c).

The notice must include the following information (Prob C §16502):

- The name and mailing address of the trustee;
- The name and telephone number of a person who may be contacted for additional information;
- A description of the proposed action and an explanation of the reasons for the action;
- The time within which objections to the proposed action can be made, which must be at least 45 days after the notice is mailed; and
- The date when the proposed action may be taken or may become effective.

A beneficiary may object to the proposed action by mailing a written objection to the trustee within the time specified in the notice of proposed action. Prob C §16503(a). A trustee is not liable to any beneficiary for taking the proposed action if the trustee does not receive a timely written objection. If no beneficiary entitled to notice objects, the trustee is not liable to any current or future beneficiary with respect to the action, provided that notice has been given to the guardian or conservator of the estate of any beneficiary who is a minor or incompetent adult. Prob C §16503(b). For a form of notice of proposed action, see §14A.4.

If the trustee receives a timely objection, a beneficiary or the trustee may petition the court to have the proposed action taken as proposed, taken with modifications, or denied. Prob C §16503(c). A trustee who decides not to implement the proposed action must notify the beneficiaries of the decision and the reasons for it. A beneficiary may petition the court to have the action taken. Prob C §16503(d). The beneficiary has the burden of proof, both in objecting to a proposed action and in petitioning to have an action taken. Prob C §16503(c)-(d).

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B. Petitioning Court for Powers Not in Trust Instrument

§2.60 1. Powers Obtainable; Conditions and Limitations

The trustee may obtain any necessary powers not granted in the instrument or by statute by petitioning the court under Prob C §17200(b)(8). See Comment to Prob C §16200.

The powers sought cannot be inconsistent with the terms of the trust instrument (Prob C §§16000, 16200) unless the trustee is asking the court to be relieved from the restriction on the exercise of a power (Prob C §16201). The trustee must show that it is necessary or desirable that he or she be given these powers to carry out the purposes of the trust. Prob C §17201. See also Prob C §17202 (court may dismiss a petition if it appears that the proceeding is not reasonably necessary for the protection of the interests of the trustee or beneficiary). See chap 16 on modification and deviation. See §2.61 on the procedure for obtaining additional trustee powers.

Under Prob C §17206, which gives the court broad discretion to make any orders and take any action necessary or proper, the court can presumably grant the power sought for a single transaction, for a specific time period, or for the duration of the trust. The attorney should request that the power continue for the trust's duration to eliminate the cost and time of going to court for many grants of the same power. Prob C §17209 (administration of trusts intended to proceed expeditiously and free of judicial intervention).

Before seeking additional powers, the attorney for the trustee should be sure that the powers will not create adverse tax consequences for the trustees or the beneficiaries. See Drafting California Irrevocable Trusts, chap 10 (3d ed Cal CEB 1997); California Will Drafting §29.7 (3d ed Cal CEB 1992). For example, Treas Reg §26.2601-1 provides guidance on the types of changes that may be made to a trust without affecting its exempt status for generation-skipping transfer tax purposes.

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§2.61 2. Procedure for Obtaining Additional Powers

The petition for additional powers can be filed at any time during the administration of the trust. When petitioning for additional powers, the trustee must follow the notice provisions set out in Prob C §17203. If the trustee anticipates the need for additional powers to deal with an imminent business opportunity, the petition seeking such powers should be brought as soon as possible because at least 30 days' notice is required before the court will hear the petition. The court may, for good cause, shorten the time for giving notice to those entitled to notice under Prob C §17203(a), but not under Prob C §17203(b).

A copy of the petition must be provided if a trustee or a beneficiary has served and filed either a notice of appearance in connection with the petition or a written request for a copy of the petition. Prob C §17205. Even if not required, a copy of the petition is often provided with the notice of hearing. See §2.62 for sample allegations in the petition and §2.63 for a sample order granting the petition.

The court may appoint a suitable guardian ad litem to represent minor, incapacitated, unascertained, or unborn beneficiaries. Prob C §1003. Although the Probate Code requires that the court appoint the guardian, the attorney representing the trustee should suggest to the court a particular individual to serve in that capacity. If the petition is simply to grant the trustee a neutral power, such as the authority to continue a business, it may be possible to have minor and unascertained beneficiaries represented by existing adult beneficiaries with identical interests. However, sometimes the interests of the income and remainder beneficiaries conflict, for example, when petitioning to continue a business in which the parent is employed. See *Estate of Lacy* (1975) 54 CA3d 172, 126 CR 432. For discussion of petitions to appoint guardian ad litem, see chap 15.

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3. Forms for Obtaining Additional Powers

§2.62 a. Form: Petition for Additional Trustee Powers

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

Trust Created Under the Will of _ _[*name of decedent*]**_ _, Deceased**	**No. _ _ _ _ _ _**
[*Or*]	**PETITION FOR ORDER GRANTING ADDITIONAL POWERS TO THE TRUSTEE (PROB C §17200)**
Trust Created by Agreement dated _ _[*date*]**_ _**	**Hearing: _ _**[*date; time*]**_ _**
[*Or*]	**Dep't: _ _**[*number*]**_ _**
In re _ _[*name*]**_ _ Trust, Established _ _**[*date*]**_ _**	**Hearing judge: _ _**[*if known*]**_ _**

_ _[*Name of trustee*]**_ _, as the Trustee of the _ _**[*name*]**_ _ Trust, which was established _ _**[*under the Will of _ _*[*name*]*_ _/under a Declaration of Trust by _ _*[*name*]*_ _*]**_ _ alleges:**

[*Add one of the following alternatives*]

[*Alternative 1: Testamentary trust*]

1. The Trust was created by a decree of the Superior Court of _ _[*name*]**_ _ County that is dated _ _**[*date*]**_ _.**

[*Alternative 2: Declaration of trust*]

1. The Trust was created under a Declaration of Trust by _ _[*name*]**_ _ on _ _**[*date*]**_ _.**

[*Alternative 3: Trust agreement*]

1. The Trust was created under a Trust Agreement between _ _[*name*]**_ _, as the Settlor, and _ _**[*name*]**_ _, as the Trustee, dated _ _**[*date*]**_ _.**

[*Continue*]

2. The trust instrument for the Trust grants powers to the Trustee in _ _[*Paragraph _ _/Section _ _*]**_ _. A copy of that trust instrument is attached as Exhibit A.**

3. To properly administer the Trust, Petitioner wishes to exercise _ _[*an/some*]**_ _ additional power(s) that is (are) not set forth in the trust instrument or conferred by statute. The requested power(s) and the reason(s) _ _**[*it is/they are*]**_ _ requested are: _ _**[*Describe power(s) requested and reason each is requested.*]**_ _**

4. The person(s) entitled to notice of this petition are:

Name and Address	Age	Interest in Trust
_____	____	_____
_____	____	_____
_____	____	_____

5. No request for special notice has been filed.

WHEREFORE, PETITIONER PRAYS:

1. That the Court make an order authorizing the Trustee to exercise the following power(s): _ _[*Describe.*]**_ _**

2. For all other proper orders.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Trustee

__[*Signature*]__
_ _[*Typed name*]_ _
Attorney for Petitioner

[*Verification; see §7.116*]

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§2.63 b. Form: Order Granting Petition for Additional Trustee Powers

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

[*Caption; see form in §2.62*] **No. _ _ _ _ _ _**
ORDER GRANTING
ADDITIONAL POWER(S) TO
THE TRUSTEE

The petition of _ _[*name of trustee*]_ _, as Trustee of the above-entitled Trust, for an order granting _ _[*an/some*]_ _ additional power(s) to the Trustee came on regularly for hearing on _ _[*date*]_ _ in Department _ _ _ of the above-entitled Court, the Honorable _ _[*name*]_ _, Judge Presiding. Petitioner appeared by _ _[*his/her/its*]_ _ counsel, _ _[*name*]_ _.

The Court finds that the facts alleged in the petition are true, that the grant of the requested additional power(s) is necessary for the proper administration of the above-entitled Trust, and that all notices of the hearing have been given as required by law.

IT IS ORDERED that:

1. Petitioner, as Trustee of the above-entitled Trust, is granted the following powers: _ _[*Fully describe the powers given.*]_ _

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

Comment: For notice requirements, see §15.40.

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C. Providing Documentation of Authority to Third Parties

§2.64 1. Certification of Trust

The trustee must occasionally provide a third party (*e.g.,* a transfer agent, title company, or purchaser of property) documentation showing that he or she has the right to exercise a particular power. Although the trustee may send the third party a copy of the first page, signature page, and page referring to powers out of the trust instrument, the trustee may instead provide the third party with a certification of trustee as provided in Prob C §18100.5. This section allows the trustee to enter into an acknowledged declaration certifying to a third party that the trustee has certain powers or may take certain actions. The third party may rely on the certification as long as the third party has no actual knowledge that the facts in the certification are incorrect. Prob C §18100.5(f).

A certification of trust may also include a legal description of any interest in real property held in the trust (Prob C §18100.5(b)(8)) and may be recorded in the county where all or a portion of the trust is located (Prob C §18100.5(c), (i)).

In addition, the certification of trust may include excerpts from the original trust document, any amendments to the trust, and any other documents evidencing or pertaining to the succession of successor trustees or that give the trustee the power to act in the pending transaction. Prob C §18100.5(c). Any person whose interest is, or may be, affected by the certification of trust may require copies of those excerpts, amendments, or documents. Prob C §18100.5(d).

For sample form, see §2.65.

PRACTICE TIP: When there is a change of trustee, an affidavit may be prepared. For discussion and a sample form of an affidavit of change of trustee that affects title to an interest in real property that can be recorded, see §§4.57-4.59. The affidavit form is similar to the certification of trust.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.65 2. Form: Certification of Trust

§2.65 2. Form: Certification of Trust

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CERTIFICATION OF TRUST

_ _[*I/We*]_ _**, the undersigned, hereby certify and declare:**

1. The name of the Trust to which this certification applies is _ _[*name*]_ _**.**

2. The Trust was created on _ _[*date*]_ _ **by** _ _[*name(s)*]_ _ **as settlor(s).**

3. The currently acting Trustee(s) _ _[*is/are*]_ _ _ _[*name(s)*]_ _**.**

4. The powers of the Trustee are as follows: _ _[*List powers or attach copy of applicable powers*]_ _**.**

[*If appropriate, add*]

5. The Trust holds the following interest(s) in real property: _ _[*Insert legal description of interest(s), assessor's parcel number(s) and street address(es)*]_ _**.**

[*Continue*]

[6.] The Trust is _ _[*revocable/irrevocable*]_ _**.**

[*If revocable, add*]

The person(s) holding any power to revoke the Trust _ _[*is/are*]_ _ _ _[*name(s)*]_ _**.**

[*Continue*]

[*If multiple trustees, add one of the following alternatives*]

[*Alternative 1 : All trustees must sign to exercise powers*]

All of the currently acting Trustees are required to sign in order to exercise the various powers of the Trustee.

[*Alternative 2: One signature required to exercise powers*]

Only one of the currently acting Trustees is required to sign in order to exercise the various powers of the Trustee.

[*Alternative 3: A majority required to exercise powers*]

A majority of the currently acting Trustees is required to sign in order to exercise the various powers of the Trustee.

[*Continue*]

[7.] The trust identification number of this Trust is _ _[*social security number/employer identification number*]_ _**.**

[8.] The Trust has not been revoked, modified, or amended in any manner that would cause the representations contained in this certification of trust to be incorrect.

[9.] This certification is being signed below by all of the currently acting Trustees of the Trust.

Date: _ _ _ _ _ _ __[*Signature*]__

_ _[*Typed name*]_ _

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF NAPA)
)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name of trustee*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

Comment: As indicated, the certification of trust must be notarized. The certificate of acknowledgment form is set out in CC §1189(a)(1). The sample form of certification of trust may be revised, within the parameters of Prob C §18100.5, to fit the particular situation. However, the form of acknowledgment should not be varied.

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§2.66 D. Discretionary Powers in General

In most instances, a trustee has some amount of discretion in exercising trust powers. Often a trust instrument contains a specific clause outlining the nature of the trustee's discretion, either with respect to a particular power or the trust powers as a whole. When exercising a power, it is important that a trustee understand the extent of his or her discretion as provided in the trust instrument. The degree to which discretion may be used is strictly construed from the language in the trust instrument and the intent of the settlor. See *Estate of Canfield* (1947) 80 CA2d 443, 181 P2d 732.

Probate Code §§16080 and 16081 provide statutory guidance for the trustee in exercising discretionary powers. In general, a trustee who is given a discretionary power must act reasonably. Prob C §16080. This exercise is also subject to review by the court, which may be obtained by petitioning the court for instructions under Prob C §17200(b)(5) (court review of exercise of discretionary powers). See *Estate of Nicholas* (1986) 177 CA3d 1071, 223 CR 410; chap 15. However, the court will not substitute its own judgment and discretion for that of the trustee if the trustee acts within proper limits. *Estate of Genung* (1958) 161 CA2d 507, 326 P2d 861.

A trustee given "sole," "absolute," or "uncontrolled" discretion must nevertheless act in accordance with fiduciary principles and not in bad faith or in disregard of the purposes of the trust. Prob C §16081(a). See also *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644.

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E. Power to Make Discretionary Distributions

§2.67 1. Power to Invade Principal

When a beneficiary is entitled to discretionary distributions, the court will generally not specify the amount to be paid even if requested to do so by a petition for instructions. The court will not interfere with a trustee's discretion unless it is being abused. *Estate of Marre* (1941) 18 C2d 184, 190, 114 P2d 586.

If, however, the trust directs the trustee to disburse funds for a given purpose, the trustee's duty to pay is not discretionary but is conditional on the existence of a reasonable necessity for the disbursement. On proof of such necessity, the court will compel payment. *Estate of Miller* (1964) 230 CA2d 888, 41 CR 410. See also *Ventura County Dep't of Child Support Servs. v Brown* (2004) 117 CA4th 144, 11 CR3d 489 (trustee of discretionary trust can be compelled under Prob C §15305 to satisfy beneficiary's child support obligations, notwithstanding spendthrift clause). But see *Young v McCoy* (2007) 147 CA4th 1078, 54 CR3d 847 (trustee of discretionary support trust did not abuse her discretion in determining that no distributions should be made to beneficiary who was serving life sentence in prison for attempted murder).

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§2.68 a. Invasion for "Health, Education, Support, or Maintenance"

Many standard clauses allow invasion of principal for the beneficiary's "health, support, education, or maintenance." Such language is used in drafting the power to invade principal under IRC §2041(b)(1)(A). The Internal Revenue Service considers the standard sufficient to prevent creation of a general power of appointment. See California Will Drafting §16.19 (3d ed Cal CEB 1992). On the "education" component of the clause, see §2.68A. On payment of income taxes as a support item, see §2.68B.

Other criteria sometimes written into the instrument to permit invasion of principal are "welfare," "reasonable number of the luxuries of life," and "the same standard of living as enjoyed by the beneficiary during the settlor's lifetime." The instrument may also provide that the income beneficiary's "needs" be considered paramount. Standards such as these give the trustee no clear guidance. A "reasonable number of the luxuries of life," for example, is an entirely subjective concept, depending in part on the standard of living enjoyed by the beneficiary before the settlor's death. A European vacation may be a routine experience for one person, a special event for another, and an incredible luxury for a third. Interpretation must be based on the settlor's intent. Even the simple term "support" depends on that intent, with the size of the trust estate and the beneficiary's lifestyle subordinately considered. 3 Scott & Ascher on Trusts §13.2.4 (5th ed 2007). See *Estate of Miller* (1964) 230 CA2d 888, 912, 41 CR 410 (trust provision for "support and maintenance" interpreted to ensure for beneficiaries same standard of living as enjoyed before settlor's death); *Estate of Hinckley* (1961) 195 CA2d 164, 170, 15 CR 570 (trust provision that trustee exercise uncontrolled discretion of payment in event of beneficiary's illness did not create fund to provide for his full support, and trustee properly determined that increasing medical costs were too high and refused payment); *Estate of Lackmann* (1958) 156 CA2d 674, 320 P2d 186 (trust provision for trustee's absolute discretion in invading principal for "proper care, support and maintenance" of one beneficiary did not allow trustee to provide no support for beneficiary while in state mental institution, notwithstanding trust clause suggesting protection of income for sibling beneficiaries).

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§2.68A (1) Definition of "Education"

Sometimes, the instrument will clarify the standard clause, *e.g.,* by limiting "education" to a 4-year college education without any graduate or professional training, or will require a specific level of academic achievement to continue receiving benefits. In other instances, the trustee must make the decision on the extent of financial assistance required under the term "education." See *Estate of Kessler* (1953) 120 CA2d 383, 387, 261 P2d 27 (interpreting "maintenance, care and education" clause as intending "increased opportunity for education, training, and development" during sole beneficiary's formative years to prepare her for successfully earning a living, rather than as accumulation of trust assets to be delivered to her at age 30). In making the determination, the trustee will have to consider the size of the trust principal and balance the needs of the income beneficiary making the request with the needs, either current or anticipated, of other income beneficiaries and remainder beneficiaries. The trustee of a "family pot" trust with limited amounts of income available to support five children, for example, may refuse to make payments for one beneficiary's education beyond graduation from a 4-year college when other beneficiaries remain to be educated, because to do otherwise might deplete the trust to such an extent that the younger children would not receive a college education.

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§2.68B (2) Payment of Income Taxes

A trustee often must determine whether a request for payment of items such as income taxes comes within the scope of the discretionary clause. Although there is no case law on point, it is arguable that the income beneficiary should reserve sufficient funds from other, nontrust, personal income for payment of his or her own income taxes, particularly when trust income makes up only a small amount of the beneficiary's total income. *U.S. v Taylor* (ND Cal 1966) 254 F Supp 752 delineates the extent of the income beneficiary's right in a support trust. When a trust provides for the beneficiary's support, the beneficiary has a "basic beneficial right" to receive payments from income, to the extent needed for support. Once the extent of the amount payable from the trust for the beneficiary's support has been determined, the property right is vested and a government lien for taxes owed may then attach to that property right under IRC §6321. 254 F Supp at 756. However, requests to pay taxes are often made under the emergency, and not support, provisions of discretionary clauses. Although it may be permissible to make such distributions the first time under an emergency clause, a trustee might be hard pressed to justify such payments on an ongoing basis. It can be argued that taxes are just another expense to be considered by the trustee in deciding how to exercise discretion.

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§2.69 b. Avoiding Depletion of Trust

The trustee must determine whether to make principal distributions within the scope of the discretionary clause that are used for the beneficiary's support, *i.e.,* whether to use principal for an income purpose. Payments that deplete trust assets potentially harm the interests of remainder beneficiaries.

The trustee should not automatically grant "support" payments with no thought to the future. Unless the trust is extremely large, it is possible that such payments will exhaust the assets before the beneficiary's death. Also, because each payment of principal reduces the amount of income generated, with the effect that the beneficiary becomes more and more dependent on payments from the principal, a perpetual diminution of trust assets results. Even if the trustee reasonably believes that the trust assets will outlast the beneficiary, given the present rate of their depletion, the possibility of emergency expenses, particularly medical expenses, must be considered.

Instead of making distributions every time they are requested for "support," the better solution is for the trustee, with his or her attorney, to point out the risks and problems of doing so to the beneficiary and attempt to help the beneficiary reduce expenditures so as not to constantly need to invade principal.

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§2.70 2. Distributions That Discharge Parent's Duty to Support Minor Children

If authorized by the trust instrument, can discretionary distributions be used to pay expenses of a minor child whose parents are still living? Basically, both parents are obligated to provide the child with support and education at a level commensurate with the respective earnings or earning capacity of the parents. See Fam C §3900. This duty is not affected by the fact that a child has his or her own estate. The minor's assets, including trust interests, can be used only if the parent is unable to meet the obligation. *Armstrong v Armstrong* (1976) 15 C3d 942, 947, 126 CR 805. Child support is not limited to basic necessities; the minor child is entitled to be maintained in a manner consistent with the parents' standard of living. *Singer v Singer* (1970) 7 CA3d 807, 87 CR 42. If there are concerns with making distributions to a parent of the minor, the parent's use of trust funds can be constrained to some extent if payments are made on behalf of the child to the minor child's "provider of the benefit" rather than directly to the parent.

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§2.71 3. Distributions of Income to Power Holder

A person with the power to make discretionary distributions (either as an individual or as a trustee or cotrustee) who is also a beneficiary of the trust must exercise the power to make a discretionary distribution to himself or herself reasonably and according to the standard in the trust instrument. Prob C §16081(b). Unless the instrument indicates that the standard is broader, the power may be exercised only for the person's health, education, support, or maintenance, and its exercise is subject to court review. Prob C §16081(c).

In irrevocable trusts, a broader standard, or even an ascertainable standard of health, education, support, or maintenance, may present income tax problems. Under IRC §678(a), a sole trustee who has power to vest some portion of income or corpus in himself or herself is deemed to be the owner of that corpus and is taxed on the income attributable to it. See Drafting California Irrevocable Trusts §9.56 (3d ed Cal CEB 1997). However, this rule does not apply with respect to a power over income if the grantor of the trust is otherwise treated as the owner of the trust under the grantor trust rules. IRC §678(b). See, *e.g.*, IRS Letter Ruling 200603040 (withdrawal power does not cause grantor's spouse to be treated as owner of a trust treated as a grantor trust because the spouse is also a discretionary beneficiary of the trust under IRC §677). For discussion of the grantor trust rules, see §11.57.

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§2.71A 4. Distributions That Discharge Personal Legal Obligations of Power Holder

A person holding a power to make discretionary distributions for the benefit of others is prohibited from using the power to discharge personal legal obligations unless the instrument so provides. Prob C §16082. Provision for discharge of the beneficiary-trustee's personal legal obligations may be unwise from a tax point of view because trust income used to discharge a personal legal obligation, *e.g.,* to pay child support (see §2.70), is taxable to the beneficiary-trustee personally. The mere power to apply trust income in this way, without actually exercising it to discharge such a legal obligation, will not, however, result in income personally taxable to the beneficiary-trustee. See IRC §678(c). See also Drafting California Revocable Trusts §4.10 (4th ed Cal CEB 2003). However, provision for discharge of the beneficiary-trustee's personal legal obligations may result in adverse estate tax consequences, irrespective of whether the power is exercised. See Revocable Trusts §§4.97, 7.22-7.25.

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5. Extent to Which Beneficiary's Outside Resources Must Be Considered

§2.72 a. Ascertaining Settlor's Intent

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In making discretionary distributions, the trustee must determine whether and to what extent to consider the beneficiary's outside resources. The instrument will control if there is a clause such as:

the trustee _ _[*shall/shall not*]**_ _ consider the beneficiary's outside resources.**

Less specific clauses leave the matter in the trustee's hands, *e.g.,* by providing that "the trustee may, but is not obligated to, consider the beneficiaries' outside resources." See, *e.g.*, *Estate of Jones* (1977) 68 CA3d 274, 279, 137 CR 138 (court interpreted express trust provisions for discretionary payments without regard to outside resources as intending that trustee "may disregard … but is not required to disregard" other assets of the beneficiary). Many trusts are silent on this issue, however, and provide no direct guidance to the trustee. California case law appears to be divided. *Estate of Ferrall* (1953) 41 C2d 166, 258 P2d 1009, concerned payment of a beneficiary's medical expenses. The court cited some out-of-state cases as the weight of authority that a trustee should consider a beneficiary's other resources before making a distribution of principal unless the trust instrument itself shows another intent. This case has been cited in 13 Witkin, Summary of California Law, *Trusts* §98 (10th ed 2005) as the California rule. Compare *Estate of Patten* (1963) 217 CA2d 167, 31 CR 767, which held that the trustee should pay the income beneficiary's expenses without first requiring her to sell or lease her real property and that the grantor had not intended that she be forced to liquidate her assets. The two cases differ in that *Ferrall* requires a contrary intent in the instrument, while *Patten* does not limit the search for the settlor's intent to the instrument. It is difficult, however, to apply *Patten* when the instrument itself is silent, because the trustee, particularly if corporate, may have no knowledge of the settlor's intent except from a beneficiary's statements, which may be self-serving. An attorney who drafted the trust instrument might have notes in the file regarding conversations with the grantor that could be helpful in explaining the settlor's intent to the trustee.

If the trust instrument is silent, unless perhaps the trustee can clearly ascertain and document the settlor's intent that other resources need not be considered, the trustee should follow *Ferrall* and consider the beneficiary's other resources. If the trustee is unsure whether a discretionary distribution is appropriate, the more practical course from the trustee's standpoint appears to be not to pay. If the trustee is challenged by the beneficiary whose request was denied, the money will still be available as part of the trust assets to distribute to the beneficiary. If, on the other hand, the trustee makes the payment and then is successfully challenged by another beneficiary, the funds are gone and, although the trustee can try to correct the earlier error in making the discretionary payment by demanding that the beneficiary return the payment, recovery might be difficult. In *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639, the court held that the trustee of a bypass trust funded with the deceased spouse's one-half share of community property could consider the surviving spouse's assets in deciding whether to invade trust principal for the survivor's support. The court noted that the survivor, who lacked capacity, owned a duplex in joint tenancy but lived in a residential care facility, and the trustee contended that the duplex was available for the survivor's support. The court implicitly took the view that making distributions to the remainder beneficiaries (nieces and nephews of the deceased spouse) was a significant purpose of the trust.

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§2.73 b. Determining Availability of Beneficiary's Own Resources

In weighing the need for a discretionary distribution against a beneficiary's resources, the instrument can sometimes guide the trustee if it provides that he or she consider assets of the beneficiary "known to the trustee," or "of which the trustee has actual knowledge," or by providing that the trustee "can rely on a statement provided by the beneficiary" concerning the beneficiary's nontrust resources.

Of these phrases, "known to the trustee" is the least helpful, because it is unclear whether the trustee must have actual facts before him or her or whether circumstantial evidence is enough. For example, the trustee may know that the beneficiary belongs to several expensive clubs or has a box at the opera. This information is not necessarily evidence that the beneficiary has the wealth to pay for such things; they could be gifts. Under any applicable provision or when the instrument is silent concerning the extent of the trustee's duty of inquiry, the trustee should ask to review a copy of the beneficiary's most recent tax return.

When the trust instrument provides that the trustee can rely on a statement provided by the beneficiary, the trustee's duty becomes problematic if he or she either knows or has strong reason to believe that the beneficiary is understating personal assets. It is probably rare for a trustee to know as a certainty that a beneficiary is understating personal assets, but, if this is the case, the first step is for the trustee, and perhaps the trustee's attorney, to discuss the matter with the beneficiary in an attempt to obtain acknowledgment of undisclosed assets. If this attempt fails, the trustee must either deny the request or petition the court for instructions, because—despite the language in the trust—the trustee should not make a discretionary distribution based on a statement he or she believes to be false.

The trustee must adequately document discretionary distributions and available outside resources in the permanent trust records, even when the trustee is a close relative and clearly knows why disbursements have been requested. See §§7.24-7.25.

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§2.74 c. Impact of Trustee's Denial of Distribution; Waste or Forced Sale of Beneficiary's Illiquid Assets

A possible problem created by a trustee's denial of a discretionary distribution because a beneficiary has sufficient outside resources is that some beneficiaries might decide to waste these assets so as to then be eligible for discretionary payments. Also, some beneficiaries might be forced to sell illiquid personal assets. Although the wasting of nontrust assets is not in the trustee's control, the beneficiary's sale of illiquid assets should be considered by the trustee in determining the extent of outside assets. Consideration of all the beneficiary's outside resources does not necessarily mean that the trustee must deny benefits simply because other resources exist. But the trustee can make an informed decision, exercising discretion, not to require the beneficiary to sell illiquid property at a loss. The important factor is that the trustee consider all the beneficiary's known assets and document this consideration. See *Estate of Patten* (1963) 217 CA2d 167, 31 CR 767 (court held that it was not settlor's intent to force sale or lease of beneficiary's house).

It is probably true that few settlors want all truly illiquid assets to be disposed of before a beneficiary can receive discretionary payments. Real property that is the beneficiary's principal residence is typically exempt, but, particularly when the beneficiary makes continual requests that result in invasions of the trust principal, other real property should not be automatically excluded. The same reasoning should apply to other illiquid assets, such as partnerships, closely held stock, and tangible personal property. To avoid undue hardship to the beneficiary while preserving the settlor's intent, the trustee should weigh the availability of these assets against the primary purpose of the trust.

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§2.75 d. Beneficiary's Ability to Seek Employment

The trustee might encounter the situation in which a beneficiary decides not to work but instead to live off the trust. If the beneficiary's needs are greater than his or her share of income under the terms of the instrument, the trustee will be faced with repeated requests for principal disbursements. Some trust instruments provide that the trustee assess beneficiaries' capacities for gainful employment and their potential earnings after completing their education. Most do not, however, with the result that the trustee will be obliged to make the payments by the terms of the instrument, regardless of his or her personal feelings about the propriety of such payments. The trustee should meet with the beneficiary to determine whether the beneficiary has the ability to find gainful employment and, if so, urge the beneficiary to go to work. In obvious cases of malingering, however, because other beneficiaries may later protest the payments, the trustee should consider petitioning the court for instructions concerning the propriety of discretionary payments to the malingerer.

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§2.76 6. Distribution From Illiquid Trust

When a beneficiary legitimately requests a discretionary distribution from an illiquid trust, the trustee might have to sell the trust assets at a loss, particularly if the beneficiary needs the funds immediately.

The trustee should consider borrowing against trust assets to raise funds needed immediately but also must consider the interest rate to be charged and the method for repayment if the asset is truly illiquid, as is, *e.g.,* a piece of undeveloped property in an area with a depressed market. When the prospect of easy repayment by the trust is slim, borrowing may simply compound the problem.

Instead of borrowing, the trustee might consider distributing the liquid assets to the beneficiary in kind if their value is close to the amount requested. However, valuing the asset in such a situation may be difficult and may leave the trustee open to later criticism from remainder beneficiaries. Also, the beneficiary may not be as well equipped as the trustee to sell the asset. Given the alternatives, the trustee and attorney should consider petitioning the court for instructions under Prob C §17200(b)(6). See chap 15.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/ IV. LICENSING REQUIREMENTS/§2.77 A. Licensing Requirements for Professional Trustees

IV. LICENSING REQUIREMENTS

§2.77 A. Licensing Requirements for Professional Trustees

To be eligible for appointment as a private professional trustee, including a nonprofit charitable corporation appointed as trustee under Prob C §15604 (see §2.78), a professional fiduciary must be licensed under Bus & P C §§6500-6592 (see §§2.79-2.82).

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.78 B. Appointment of Private Professional Trustee

§2.78 B. Appointment of Private Professional Trustee

Probate Code §15604 allows a nonprofit charitable corporation to be appointed as a private professional trustee only if:

- The corporation is incorporated in California;
- The articles of incorporation specifically authorize the corporation to accept appointments as trustee;
- For the 3 years before the petition for appointment is filed, the nonprofit corporation has been tax-exempt under IRC §501(c)(3) and has served as a private professional conservator (see former Prob C §2341(a)) in California;
- The settlor or an existing trustee consents to the appointment of the nonprofit corporation as trustee or successor trustee, either in the petition or in a writing signed either before or after the petition is filed;
- The court determines that the trust is in the best interest of the settlor; and
- The court determines that the appointment of the nonprofit corporation as trustee is in the best interest of the settlor and the trust estate.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.79 C. Licensure by Professional Fiduciaries Bureau

§2.79 C. Licensure by Professional Fiduciaries Bureau

The Professional Fiduciaries Act (Bus & P C §§6500-6592) creates a Professional Fiduciaries Bureau in the Department of Consumer Affairs and requires the bureau to license and regulate professional fiduciaries. Any person who acts as a professional fiduciary, or holds himself or herself out to the public as a professional fiduciary (see §2.80), must be licensed as a professional fiduciary unless that person is licensed as an attorney or a certified public accountant or is enrolled as an agent to practice before the IRS. Bus & P C §6530.

The license must be renewed annually by filing a renewal application with the bureau and submitting the required annual statement, renewal fee, and proof of compliance with the continuing education requirement. Bus & P C §6541. On licensee information requirements, see §2.81. On educational requirements, see §2.82.

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§2.80 1. Definition of "Professional Fiduciary"

"Professional fiduciary" under Bus & P C §6501(f) includes a person who acts as a trustee "for more than three people or more than three families, or a combination of people and families that totals more than three, at the same time, who are not related to the professional fiduciary by blood, adoption, marriage, or registered domestic partnership." A superior court may not appoint a person to carry out the duties of a professional fiduciary or permit a person to continue the duties of a professional fiduciary unless he or she is licensed as a professional fiduciary or is exempt from the licensure requirement. Prob C §2340. See also Prob C §60.1 (no person shall hold himself or herself out to the public as a professional fiduciary unless licensed as a professional fiduciary).

There are various exceptions to this definition of professional fiduciary for trust companies, FDIC-insured institutions, specified public employees, and specified persons whose sole activity as a fiduciary is as a registered and regulated broker-dealer, broker-dealer agent, investment adviser, or investment adviser representative. Bus & P C §6501(f)(1)-(5).

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.81 2. Licensee Information Requirements

§2.81 2. Licensee Information Requirements

The information to be maintained by the bureau in each licensee's file includes (Bus & P C §6534):

- The names of the licensee's current conservatees or wards and the trusts currently administered by the licensee;
- The aggregate dollar value of the assets currently under the licensee's supervision as a professional fiduciary;
- The licensee's current address and telephone number for his or her place of business and place of residence;
- Whether the licensee has been removed as a fiduciary by a court for breach of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference, or the licensee has demonstrated a pattern of negligent conduct, including a removal prior to becoming licensed; and
- The case names, case numbers, and court locations of all conservatorships, guardianships, or trusts or estate administration cases that are closed for which the licensee served as conservator, guardian, trustee, or personal representative.

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Source: Estate Planning/California Trust Administration/2 Overview of Trustee's Duties, Standards, and Powers/§2.82 3. Educational Requirements

§2.82 3. Educational Requirements

Basic educational qualifications for licensure (baccalaureate degree or associate degree combined with 3 years of work experience) are specified in Bus & P C §6533. Criminal background checks will performed on each applicant as provided in Bus & P C §6533.5.

Professional fiduciaries will be required to complete 30 hours of prelicensing education courses and 15 hours per year of continuing education courses provided by an educational program approved by the bureau (Bus & P C §6538) and pass a licensing examination to be administered by the bureau (Bus & P C §6539).

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Cotrustees and Shared Fiduciary Powers

CEB Staff

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§3.1 I. ALLOCATION OF TRUSTEE POWERS

All cotrustees must act unanimously to bind the trust, unless the trust provides otherwise. Prob C §15620. The trust instrument can allocate powers unequally among cotrustees. There is no limit to the trust powers that can be allocated, but the most common allocations are of the powers to invest and to make discretionary distributions. The instrument can also grant specified powers to a beneficiary or a third party who may be designated a "special trustee." The settlor can retain express powers to direct acts of the trustee or cotrustees.

In this chapter, the term "holder of the power," unless otherwise defined, denotes the person holding greater powers over the trust when:

- One cotrustee has one or more powers superior to those of the other cotrustees;
- An individual (a beneficiary, a third party unrelated to the trust, or a person named as special trustee) can direct the trustee or trustees in certain situations (*e.g.,* investments or discretionary distributions); or
- The settlor retains stated powers to direct the trustee or trustees.

When two or more persons exercise trustee powers, practical and legal problems may arise from the manner in which these powers are allocated. The allocation of trustee powers should be carefully reviewed by all cotrustees, special trustees, and their attorneys at the onset of trust administration.

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§3.2 II. COTRUSTEES' DUTY TO ACT JOINTLY

Unless otherwise provided in the trust instrument, a power vested in two or more cotrustees may be exercised only by their unanimous action. Prob C §15620. If a cotrustee is unavailable to perform the duties of a cotrustee due to specified circumstances, the remaining cotrustees may act when necessary to accomplish the purposes of the trust or to avoid irreparable injury to the trust property. Prob C §15622. See §3.5.

NOTE: The requirement of unanimity for cotrustees differs from the law applicable to joint personal representatives. Under Prob C §9630, two joint representatives, or a majority of representatives if there are more than two, must concur to exercise a power, but if one or more joint representatives are absent from the state, unable to act, or legally disqualified from serving, the remaining representatives can act, but only on court order. The legislative history does not explain why the law differs for personal representatives and trustees.

One duty of cotrustees is to vote the proxies on securities held in the trust. In voting the shares, unanimity of the cotrustees is not required. A majority action is binding, because Corp C §704, which specifically governs multiple fiduciaries having the same fiduciary relationship with respect to the same shares of stock, takes precedence over the general rule of Prob C §15620. *Edwards v Edwards* (1998) 61 CA4th 599, 71 CR2d 653.

Cotrustees may not delegate their responsibilities to another cotrustee or anyone else, with the exception of investment and management functions under Prob C §16052. Even when specific duties are properly delegated, each trustee must exercise general supervision over the trust. Prob C §16012.

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§3.3 A. Acts to Bind Trust Property

There is no statutory or case law clearly explaining what constitutes the exercise of a power under Prob C §15620. *Stanton v Preis* (1955) 138 CA2d 104, 291 P2d 118, provides a limited interpretation of the requirement of unanimity of action under former CC §§860 and 2268, predecessors of §15620. In *Stanton,* after one cotrustee appealed a probate court decision allowing modification of the trust, the other cotrustee and the beneficiaries moved to dismiss the appeal on the grounds that the cotrustees had not acted unanimously in filing it. The court of appeal held that the case did not involve the kind of "power" that the statute required to be exercised unanimously in order to bind trust property. Rather, the cotrustee was exercising a legal capacity to obtain court interpretation of the trust instrument. The court distinguished this from actions such as the exercise of a power to sell property, which would clearly require unanimity.

The *Stanton* opinion neither addressed the general issue of which powers can be allocated nor discussed whether other petitions to the court could be filed by one cotrustee. As a practical matter, any one cotrustee should be allowed to petition the court for instructions. Otherwise, there would be no means of breaking a stalemate or settling a disagreement among cotrustees.

Although there is no law on point, it seems reasonable that, if an act can be lawfully delegated to a third party (see chap 2), the act is not a "power" under Prob C §15620 and therefore could be taken by a single cotrustee. Conversely, if the act cannot be delegated to a third person, §15620 would prohibit its exercise by a single cotrustee.

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B. Administration of Trust

§3.4 1. Day-to-Day Activities; Delegable Duties

Unless the trust agreement provides otherwise, all cotrustees must take an active role in administering the trust. See Prob C §15620. A cotrustee's failure to participate in trust administration could constitute unlawful delegation. "Ministerial acts," *i.e.,* those not requiring the exercise of personal judgment, can be delegated. In addition, investment and management functions may be delegated. Prob C §§16012, 16052. For general discussion of delegation, see chap 2. For discussion of delegation of investment functions, see chap 5.

To avoid unlawful delegation and provide for effective management of the trust, at the inception of the trust the cotrustees should agree in writing on a management method that will involve all cotrustees in active management and appropriately allocate ministerial duties. For a sample agreement dividing recordkeeping and accounting responsibilities, see §7.6. Counsel for the trustees should review the agreement to ensure that only actions that may be delegated are included. Attorney fees for this task should be a proper charge against the trust under Prob C §15684.

One cotrustee should keep the trust's books and records and have physical possession of the assets. This will be the corporate cotrustee, if there is one. Because the cotrustee who keeps the books will usually receive correspondence from third parties, this trustee will often have the day-to-day responsibilities of managing the trust.

The cotrustees must agree on a method for consulting with each other when joint action must be taken. The safest consultation method is for the cotrustee who handles the day-to-day trust administration to inform the other cotrustees in writing of the administrative activities performed on behalf of the trust. When an action is proposed, all cotrustees should affirm or reject it in writing, explaining the facts and circumstances favoring or opposing the intended action. If there is insufficient time for writing, telephone conversations followed by written confirmation are appropriate.

Although written communications may seem cumbersome, particularly in small trusts or trusts of close family relationships, a clear and complete record of actions taken will protect all cotrustees if an action is later challenged by a beneficiary.

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§3.5 2. When Cotrustee Is Unavailable

Events beyond the cotrustees' control may require immediate action when a cotrustee is unavailable. When a cotrustee is unavailable due to absence, illness, or other temporary incapacity, the remaining cotrustee or cotrustees may act when necessary to accomplish the purposes of the trust or to avoid irreparable injury to the trust. Probate Code §15622. It is advisable to document the circumstances constituting unavailability, the necessity for action, and the action taken.

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§3.6 3. Disagreements Among Cotrustees

When cotrustees disagree, either a stalemate develops and no action is taken, or action is taken contrary to the best judgment of one or more cotrustees. In either case, one alternative way to resolve the problem is to petition the court under Prob C §17200(b)(6) for instructions. A cotrustee can petition the court without the consent of the other cotrustees. See *Stanton v Preis* (1955) 138 CA2d 104, 291 P2d 118, discussed in §3.3.

If one cotrustee takes an action that another cotrustee considers a breach of fiduciary duty, the objecting cotrustee should petition the court under Prob C §16420 either to enjoin further improper conduct or to set aside the action. A cotrustee who fails to seek the court's intervention to undo a cotrustee's breach of trust may be personally guilty of a breach of trust and liable for any damage that results. See §3.23.

If the cotrustees regularly disagree, a cotrustee should consider either resigning or petitioning for removal of the other cotrustee under Prob C §§17200(b)(10) and 15642(b)(3), alleging that the lack of cooperation has impaired the proper administration of the trust. See chap 4.

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§3.7 III. UNEQUAL ALLOCATIONS OF FIDUCIARY RESPONSIBILITIES

The trust instrument may allocate trust powers unequally, either among cotrustees, or between a cotrustee and a settlor, beneficiary, or third party. See Prob C §15620. The trust instrument can also grant to a third party who is not a cotrustee powers over the trust equal to or greater than those given the trustee. Ideally, the trust instrument will clearly specify any unequal allocation of powers, so that the parties understand the allocation of powers and their duties and responsibilities. If a revocable trust instrument is unclear, the settlor's attorney should suggest an amendment to clarify the allocation. The trustees of an irrevocable trust should petition the court for instructions to obtain an order clarifying the allocation.

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A. Persons to Whom Power Can Be Allocated

§3.8 1. Cotrustees

The settlor can allocate powers among cotrustees in various ways, *e.g.,* one cotrustee may direct the other cotrustee, or one cotrustee may be given full power over investments while the other is responsible only for bookkeeping functions. The trust instrument can also allocate to one cotrustee the power to make discretionary distributions.

When investment powers are allocated among cotrustees, the cotrustee with the lesser power must be careful not to delegate to the cotrustee holding the greater power any additional authority not granted by the trust instrument. For example, a trust may provide that one cotrustee has the power to veto all sales of real estate. Such a provision does not confer a general veto power, *e.g.,* over sales of securities. Further, a cotrustee with investment power cannot allow a cotrustee with veto power over a specific type of investment to exercise a veto power over all investments. This would constitute an improper delegation of a fiduciary duty. Regardless of the allocation of fiduciary responsibility among cotrustees, all cotrustees have residual fiduciary duties.

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§3.9 2. Beneficiaries

Trusts often allocate certain powers to a beneficiary who is not named as cotrustee. For example, one or more beneficiaries, or a majority of beneficiaries, may exercise all powers of investment. Alternatively, a beneficiary may have the power to direct specified investments or to direct all investments, leaving the trustee with bookkeeping responsibilities only. The trust may give a beneficiary veto power over any investment, or it may provide that the trustee must consult with the beneficiary but need not accept the beneficiary's position regarding the proposed action. The trustee must not delegate any powers beyond those allocated to the beneficiary by the trust instrument. For example, if the beneficiary has only the power to veto investment decisions, the trustee cannot accept a direction from the beneficiary to make a certain investment.

The trust instrument can also grant to a beneficiary the right to direct the trustee to make discretionary distributions. If there are multiple beneficiaries, a beneficiary with power over discretionary distributions must exercise the power as a fiduciary would or be subject to a suit for breach of trust by other beneficiaries. See §3.12 and California Will Drafting §28.3 (3d ed Cal CEB 1992). Even if a beneficiary is allocated such powers, the trustee may have residual fiduciary duties, depending on the language of the instrument.

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Source: Estate Planning/California Trust Administration/3 Cotrustees and Shared Fiduciary Powers/§3.10 3. Settlor

§3.10 3. Settlor

A settlor of a revocable trust may expressly retain final investment authority or other powers. When a trust is to continue beyond the settlor's lifetime, the settlor may want firsthand evidence that the trustee is willing and able to carry out the trust's investment directions. Therefore, while the settlor is alive and the trust is still revocable, the settlor may want to allocate the bookkeeping burden to the trustee while retaining the investment power. The trust can provide that

- The settlor has the power to direct any or all investments from time to time;
- The trustee must consult with the settlor and obtain the settlor's approval for any action (veto power);
- The trustee must consult with the settlor before making investments (no veto power);
- The settlor has all investment power, leaving the trustee with only bookkeeping and custodial responsibilities.

The trustee of a revocable trust must follow acceptable written directions from the person with power to revoke the trust or the person to whom the settlor grants a power to direct the trustee. Prob C §16001(a). Probate Code §16001(b), however, requires that any direction having "the effect of modifying the trust" must comply with the statutory requirements for modification of revocable trusts.

NOTE: Arguably, any direction inconsistent with the terms of the trust instrument would have the effect of modifying it, rendering the provisions of Prob C §16001(a) uncertain.

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§3.11 4. Third Parties; Special Trustees

Trusts occasionally allocate powers to a party unrelated to the trust. These third parties may be given any trust power, *e.g.,* investment powers or powers over discretionary distributions. Often, investment powers are allocated to an investment counselor or broker with whom the settlor has a long-standing relationship that the settlor wishes to continue. Investment power is often given to a trusted friend, a CPA, a business acquaintance, or a relative who is not otherwise connected with the trust. A third party with special expertise may be given authority to manage a special asset such as an art collection. The power to direct discretionary distributions may be allocated to a third party whose familiarity with the beneficiaries' needs and circumstances is greater than the trustee's.

If the trust instrument names an investment counselor to direct trust investments, it should state whether the power is vested in the firm or in a certain individual. If an individual is given the investment power, the instrument should state whether the power exists only while the person is employed by the named firm and state what should be done if the named individual dies or becomes disabled. If an investment firm is named, the trust should provide what happens on the division, merger, or termination of the firm. This avoids a dispute among the trust and various members of the former firm claiming to hold the power on behalf of themselves or their new firm. If the trust instrument is unclear and any of these situations occur, the trustee's only remedy is to petition the court for instructions.

The trustee must not delegate to the special trustee or other third party any authority not provided in the trust instrument. Also, the trustee may have residual fiduciary duties, depending on the language of the trust.

NOTE: A special trustee or other party to whom a power has been allocated must exercise that power as a fiduciary. See §3.12.

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§3.12 B. Holding Trust Powers in Fiduciary or Beneficial Capacity

If the holder of a power has no beneficial interest in the trust, the power is held in a fiduciary capacity. If the holder of the power is the only party with a beneficial interest in the trust, such as the settlor of a revocable trust, the power is held in a beneficial capacity. When the holder of the power is one of several beneficiaries, the power may be held either in a fiduciary or a beneficial capacity.

If the holder of a power does not have the sole beneficial interest in the trust, the power is held in a fiduciary capacity if the holder is acting for others. See *Crocker-Citizens Nat'l Bank v Younger* (1971) 4 C3d 202, 212, 93 CR 214. A power may, however, be held for the benefit of a single beneficiary. If that beneficiary is the powerholder, the power is held in a beneficial capacity. For example, a power given to a widow to prevent the sale of a residence held in trust is ordinarily a power for the benefit of the widow only. Restatement (Third) of Trusts §75, Comment c (2007); Restatement (Second) of Trusts §185, Comment c (1959). The extent of the holder's rights and duties depends upon the circumstances, and no exact rules can be stated. Restatement (Second) §185.

The rules pertaining to trustees are broadly applicable to nontrustees holding powers in a fiduciary capacity. *Crocker-Citizens Nat'l Bank v Younger* (1971) 4 C3d 202, 211, 93 CR 214. As a fiduciary, the holder of the power must invest the trust assets prudently (see chap 5) and must avoid any conflict of interest (see chap 2). Some distinctions can, however, arguably be made between cotrustees and nontrustee holders of powers in a fiduciary capacity. For example, although cotrustees with equal powers are subject to joint liability under Prob C §16402, it is questionable whether nontrustees should have an affirmative duty to monitor, and be subject to joint liability for, a trustee's actions.

When a power is held in a beneficial capacity, there are few limitations on the holder of the power and on the trustee. In fact, the trustee's only duty is to ascertain whether the exercise of the power is within the terms of the trust. Restatement (Third) of Trusts §75, Comment d (2007). For example, if a trust restricts investments to municipal bonds, the trustee must object if the holder of the power wants to invest in a limited partnership.

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§3.13 C. Capacity of Holder of Power

A person to whom trust powers have been allocated must have the capacity to exercise these powers. A properly drafted trust instrument requires that the holder of a power can exercise the power only while retaining capacity. The instrument should set out standards for determining capacity.

There are several methods of determining capacity. The instrument can provide that the holder of the power must be capable, in the trustee's discretion, of properly handling the holder's own affairs. This method allows the trustee flexibility to determine incapacity and avoids a possibly distasteful court hearing on the issue. A trustee may be reluctant to act, however, without more explicit guidelines. To avoid allegations that the trustee has acted improperly, the trustee should clearly document the basis for the incapacity determination. Documentation is no problem if the holder of the power is hospitalized or has had a conservator appointed. Absent such demonstrable evidence, if the trustee believes that the judgment of the holder of the power has deteriorated to such an extent that his or her actions are detrimental to the trust, the trustee must document specific incidents proving the fact. The trustee must thereafter refuse to accept the holder's instructions. To do otherwise would be a breach of fiduciary duty. If the holder of the power disputes this decision, the trustee should petition the court for instructions under Prob C §17200(b)(6). If the court refuses to remove the holder of the power, the trustee will be protected by the court order in following the holder's subsequent directions. If additional facts concerning the holder's capacity develop after obtaining the court order, the trustee should again bring the facts before the court by a petition for instructions.

Some trust instruments provide that the holder of the power is deemed incapacitated when, in the opinion of one or more licensed physicians, the holder is incapable of managing the holder's own affairs. A doctor may be unwilling to give this statement, however, unless the situation is clear cut, to avoid becoming embroiled in a family argument or a court battle, or because of concerns about confidentiality of medical information under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) (Pub L 104-191, 110 Stat 1936) (particularly the HIPAA privacy provisions found in 42 USC §1320d-2 and 45 CFR pts 160, 164) and California's Confidentiality of Medical Information Act (CMIA) (CC §§56-56.37). If the trustee cannot obtain a supporting opinion from one or more physicians, as required by the instrument, the only recourse is to petition the court for instructions.

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Source: Estate Planning/California Trust Administration/3 Cotrustees and Shared Fiduciary Powers/§3.14 IV. ALLOCATING INVESTMENT AUTHORITY

§3.14 IV. ALLOCATING INVESTMENT AUTHORITY

Of all shared trust powers, investment powers are the greatest cause of concern during trust administration. Trusts generally allocate investment authority in one of four ways:

- One or more persons are given the power to direct others;
- One or more persons are empowered to veto actions by others but not initiate actions;
- The trustee or cotrustees are required to consult with another person who does not have a right to veto or direct actions; or
- One person is granted all investment powers, but no powers over other trust actions.

Any combination of the above allocations is possible.

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§3.15 A. Administrative Issues in Unequal Power Situations

In any shared-power situation, the trustee and the holder of the power, whether a cotrustee, beneficiary, or third party, should reach an agreement on the allocation of powers. The trustee's attorney should advise the holder of the power that the attorney represents only the trustee. The holder of the power should consult separate counsel if there is a disagreement regarding the allocation. If the language is ambiguous or deficient and the trust is revocable, the trustee and the holder of the power should ask the settlor to amend the trust to rectify this problem. If the language is ambiguous or deficient and the trust is irrevocable, the trustee should petition the court under Prob C §17200(b) for an interpretation or for modification of the trust to remedy the ambiguity.

The trustee and holder of the power should establish a compatible working relationship within the exact allocation of powers. Hostility between cotrustees that impairs proper administration of the trust can be grounds for removal of a trustee. Prob C §15642(b)(3); *Estate of Gilmaker* (1962) 57 C2d 627, 21 CR 585. See chap 4. The holding in *Gilmaker*, which involved a "beneficiary-consultant," should also apply to all nonbeneficiary holders of powers, although there is no case on point. Although Prob C §15642(b)(3) refers only to problems "among cotrustees," the court should have adequate power under Prob C §17200 to resolve an unworkable relationship between a trustee or cotrustees and a special or third party power holder.

The trustee and holder of the power should also decide at the outset whether the trustee should accept only written instructions from the holder of the power, even if not required to do so by the trust instrument. The strongest argument for accepting only written instructions is that they provide a record that could be needed if questions arise. Written instructions may not always be feasible, however, even in trusts requiring written instructions, particularly when a decision must be made quickly. In that case, the trustee may wish to accept oral instructions followed by a confirming letter, e-mail, or telegram. If the trustee does not receive written confirmation from the holder of the power, the trustee should write to the holder of the power setting forth the investment direction and asking the holder to sign and return the letter as confirmation. The trustee must be aware that there is always a degree of risk if the holder of the power does not send written confirmation.

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B. Power to Direct Investments

§3.16 1. Scope of Power

A settlor may retain the power to direct trust investments or may allocate it to a cotrustee, beneficiary, or third party. A trustee who does not hold the power to direct investments is not thereby relieved of investment responsibility, unless the trust instrument allocates that responsibility exclusively to the holder of the power. A partial investment power allows the holder to intervene at will in investment decisions, but, if the power is not exercised, the nonpowerholding trustee should handle trust investment activities as if the trustee alone has responsibility for investment decisions. If a cotrustee holds the power and chooses not to direct an investment, the abstaining cotrustee may be improperly delegating his or her power. See Prob C §15620. The acting trustee may need to petition under Prob C §17200(b)(6) for instructions.

The holder of the power to direct investments may attempt to expand that power into total control over the investment activities by giving the trustee or cotrustee a standing direction to take no action over trust investments without his or her approval. This would be an improper modification of the trust, changing the power to direct into a power to veto, and must not be followed by the trustee.

Sometimes, an individual holding a power of direction will hire an investment counselor and instruct the trustee to follow the counselor's investment instructions directly rather than waiting for instructions from the holder of power. In this case, the nonpowerholding trustee will not know, for any particular investment decision, whether the investment counselor has obtained the approval of the person holding the power to direct. This raises a delegation problem except when the settlor of a revocable trust retains the power to direct the trustee and then appoints an investment counselor to direct investments. See Prob C §16001(a). In other situations, there may be an unlawful delegation by both the person holding the power to direct and the nonpowerholding trustee. To avoid this problem, the individual holding the power to direct investments should convey all investment decisions to the trustee after independently reviewing them.

In practice, however, the investment counselor often conveys investment instructions directly to the nonpowerholding cotrustee. It can be argued that, by selecting the investment counselor and consulting with the counselor periodically, the holder of the power is fulfilling the trust investment responsibilities. Time constraints and time-limited opportunities may militate for this procedure, though it is not technically correct. The trustee's attorney should advise the trustee that a court could find that this practice constitutes unlawful delegation unless specifically sanctioned by the trust instrument.

NOTE: While the authority of a holder of an investment power, as opposed to a trustee, to delegate investment decisions to an investment advisor raises the potential for accusations of abuse of fiduciary duty, Prob C §16052 specifically authorizes a trustee to delegate investment and management functions as prudent under the circumstances.

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§3.17 2. Protecting the Nonpowerholding Trustee

Trust provisions that confer the power to direct investments on someone other than the trustee often include exculpatory language limiting the trustee's liability for following the directions of the holder of the power. This type of clause relieves the trustee from liability for any action taken when following the directions of the holder of the power. It may also relieve the trustee from the duty to review those investments directed by the holder of the power and from liability for any consequences of not doing so.

Many "power to direct" clauses, however, fail to include a release from the responsibility to review actions taken, and thus create difficulties for the trustee. Although the trustee will not be responsible for the initial decision, the trustee must periodically review the directed investment along with all other investments under the trustee's supervision. This is undesirable for the trustee if the holder of the power has caused the trust to invest in an asset that is difficult to monitor, such as a limited partnership or shares of a closely held company.

PRACTICE TIP: A corporate trustee acting while the settlor is still alive and the trust is amendable may request that a release from the responsibility to review directed investments be added to the trust to avoid incurring liability for reviewing investments. In California, however, no case law has validated language relieving the trustee of the duty to review directed investments. For further discussion, see §§3.22-3.23.

If the trust does not specifically relieve the trustee of liability, the extent of the trustee's responsibility and liability depend on the status of the holder of the power. Although no California case discusses this issue, unless the power is held solely as a beneficial interest, it is arguable that the trustee must review directions to make sure they meet fiduciary standards. In particular, the trustee must ensure that the holder of the power is not directing an investment in which the powerholder has a conflict of interest. For example, the holder might direct the trustee to invest trust assets in XYZ Company, in which the holder is a controlling shareholder. Because the holder, whether or not named a cotrustee, arguably is subject to fiduciary standards when directing trust investments (see §3.12), this would be an impermissible conflict of interest. See chap 2.

It may be difficult to determine whether the holder has a conflict of interest. It is reasonable to suggest that the trustee should make basic inquiries about investments with which he or she is unfamiliar. For closely held corporations or partnerships, the trustee should examine ownership and corporate documents. The trustee can also ask the holder outright if he or she has any interest in the investment.

If the trustee has doubts about the action he or she is directed to take or questions whether the action involves a conflict of interest, the only recourse is to seek instructions from the court. See chap 15.

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§3.18 C. Veto Power

A trust may give another person *e.g.,* a beneficiary, a cotrustee, a third party, or a settlor, veto power over the trustee's investment decisions. See Drafting California Revocable Trusts, §17.33 (4th ed Cal CEB 2003) and California Will Drafting, chap 28 (3d ed Cal CEB 1992) on allocating this power to the individual cotrustee. The veto power can be limited to particular investments, such as real property, or can apply to all investments. A veto power usually requires that the trustee review investments and propose actions to the holder of the power and obtain that person's consent before taking any action. Therefore, the trustee cannot take any affirmative action without the prior approval of the holder of the power or, in some cases, unless a specified amount of time has elapsed without the powerholder's response. This type of clause is sometimes called a "consultation and approval clause."

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§3.19 1. Scope of Power

The holder of the veto power cannot independently initiate any investment actions, but must await a proposal by the trustee. The settlor may grant the veto power in order to obtain the benefit of the holder's particular investment judgment without allowing the holder to actively impose his or her investment philosophy on the trust.

The trustee remains responsible for making investment decisions. He or she must not allow the holder of the power to turn a veto power into a power of direction. A trustee who acquiesces in this transformation would be improperly delegating basic investment authority and, in effect, impermissibly amending the terms of the trust.

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§3.20 2. Protecting the Nonpowerholding Trustee

Most trust instruments contain exculpatory provisions to protect the trustee from liability if the holder of the veto power fails to approve the trustee's proper investment recommendations. Because the holder of the veto power does not have the power to direct the trustee to take investment actions, language relieving the trustee of the duty to review investments is unnecessary. See §§3.17, 3.22.

If the holder of the veto power repeatedly vetoes prudent investment recommendations of the trustee and those vetoes result in serious losses to the trust that defeat the purposes of the trust, the trustee should consider petitioning the court to remove the power holder for breach of fiduciary duty.

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§3.21 D. Consultation Power

Some trusts require the trustee to consult when practicable with a third party consultant before making investments. When the trustee is required only to *consult* the third party, the consultant's *approval* of investments is unnecessary. The trustee's attorney should explain those features to both the trustee and the consultant to avoid any misunderstanding that could impede the proper administration of the trust.

Trustees subject to a consultation clause must consult with the person named in the instrument when practicable before taking any action covered by the clause. The trustee must decide when it is practicable, usually on a case-by-case basis. The trustee should clearly document whether he or she attempted to consult and, if not, the reasons why this was not practicable. Some consultation clauses require consultation in every investment decision. In that situation, problems may arise if the consultant is unavailable.

When consultation is required, the trustee must provide sufficient time for the consultation before carrying out the proposal. The trustee's ability to act against the consultant's wishes does not relieve the trustee of the duty to consult; nor does it allow the trustee to manipulate the situation so that there is insufficient time for the consultant to consider the issue and make a recommendation. Either act would constitute a breach of the trust by the trustee. Although a nonbeneficiary consultant has no standing to petition the court for instructions under Prob C §17200, or to allege a breach of trust by petitioning the court under Prob C §§16400-16403, a consultant who believes that the trustee is in breach of trust may wish to petition the court on the theory that there is no other forum. Of course, a beneficiary may petition the court if there is any loss to the trust due to the trustee's failure to consult.

The trustee should document the consultation with a copy of the trustee's letter requesting advice and a copy of the consultant's response or a note of any oral response. Some trusts provide that, if the consultant fails to respond within a specified time, the trustee may act on the proposal. In such cases, the trustee should document that the period expired before any action was taken. Usually, documentation or confirmation of the investment action also reflects the date of the transaction. Some trusts specify when the time period for a response begins to run; others are silent. If the beginning of the period is not specified, the trustee and consultant should have a written agreement, filed with the other trust documents, establishing when the period begins.

The trustee must not delegate his or her investment authority to the consultant. For example, even if the consultant's advice appears excellent, the trustee must still independently evaluate it. To do otherwise might give rise to the very situation the settlor wished to avoid by including a consultation clause rather than a veto power. If the consultant is, *e.g.,* a financial planner or investment advisor, the trustee may nevertheless delegate investment and management functions, as prudent under the circumstances, to the consultant, as provided in Prob C §16052.

The trustee must consider information that the consultant provides, particularly when it pertains to the beneficiaries' needs and how they might be affected by a proposal. For example, if the trustee proposes to sell high-earning securities to purchase lower-yield tax-exempt issues, the trustee should consider information provided by the consultant that indicates the beneficiaries need greater gross income. The trustee should also make independent efforts to verify the consultant's information before making investment changes.

Exculpatory language protecting the consultant is unnecessary when the trustee is required only to consult, but is not bound to follow, the consultant's recommendations. The trustee has full power over the investments of the trust.

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§3.22 E. Investment Power Allocated Entirely to Holder of Power

Some settlors do not want the trustee, or one particular cotrustee, to make any investment decisions. This is most often the case when the settlor has chosen a corporate trustee to perform professional bookkeeping functions and to hold records of the trust's activity for continuity over generations, or to make discretionary distributions. The settlor may consider the corporate trustee's investment policies too conservative for the needs of the trust beneficiaries. In this situation, the corporate trustee is expressly relieved of all investment responsibility. The party given the investment power may be the settlor, a beneficiary, a cotrustee, or a third party, such as an investment counselor.

Trust clauses that grant full power to invest provide that the person holding the power has all responsibility over trust investments and expressly provide that the nonpowerholding trustee has no right or responsibility concerning the investments of the trust. The attorney should explain the respective roles to the trustee and holder of the power, so that the holder does not later attempt to excuse inattention to trust assets by claiming that he or she believed the trustee to be reviewing them.

When someone other than the trustee has total control over trust investments, most trusts expressly relieve the trustee of liability for actions or inaction by the holder of the power. Many trustees refuse to act in the absence of such exculpatory language. The language should protect the trustee not only from liability arising from the holder's actions but also from the holder's inaction. This protects the trustee when, for example, the holder fails to sell a security in a company known to be near insolvency. When the parent company goes into bankruptcy, the beneficiaries could otherwise sue the trustee for failing to take action.

CAVEAT: Regardless of the language in the trust instrument, the trustee may be liable for failing to act if he or she knows that the holder of the power is acting imprudently.

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§3.23 V. COTRUSTEE LIABILITY

A cotrustee is generally not liable to the beneficiary for a breach of trust committed by a cotrustee. Prob C §16402(a). The cotrustee is, however, liable to the beneficiary if the cotrustee (Prob C §16402(b)):

- Participates in a breach of trust committed by a cotrustee;
- Improperly delegates the trust administration to a cotrustee;
- Approves, knowingly acquiesces in, or conceals a breach of trust committed by a cotrustee;
- Negligently enables a cotrustee to commit a breach of trust; or
- Neglects to take reasonable steps to compel a cotrustee to redress a breach of trust when the trustee knows, or has information from which the trustee reasonably should have known, of the breach.

These exceptions to the nonliability rule are so broad that there are few cases in which a cotrustee would not be liable. Absent extensive provisions in the trust instrument negating the general rules governing any cotrustee's involvement in the administration of the trust (see, *e.g.,* Prob C §16013), it is difficult to construct a realistic example of a cotrustee breach that would not fall within one of the exceptions.

To avoid liability, therefore, each cotrustee must be constantly aware of the affairs of the trust and remain in regular communication with the other cotrustees. If any cotrustee fails or refuses to cooperate in this process, the remaining cotrustees should consider a petition for removal under Prob C §15642(b)(3).

A cotrustee who believes that another cotrustee may have committed a breach of trust is not relieved of responsibility by resigning. If the resignation enables the cotrustee to commit the anticipated breach of trust, the resignation itself could be deemed a breach of the duty to take reasonable steps to prevent a cotrustee's breach. See Prob C §§16013(b), 16402(b)(4).

NOTE: The Comment to Prob C §16013, which requires each cotrustee to participate in the administration of the trust and take steps to prevent or compel redress of a cotrustee's breach, states (18 Cal L Rev'n Comm'n Reports 668 (1986)):

> If a cotrustee is also a settlor under a revocable trust, a cotrustee who is not a settlor has a duty to follow the directions of the settlor-cotrustee pursuant to Section 16001. That duty supersedes the general duty under this section.
>
> If a settlor as cotrustee gives a direction to the nonsettlor cotrustee that has the effect of modifying the trust, however, Prob C §16001(b) requires a formal amendment, and it is questionable whether the Comment to §16013 quoted above would apply. The Comment refers to §16001 prior to its amendment, which added §16001(b). See §3.10 for discussion of Prob C §16001.

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4

Rejection of Trust; Resignation and Removal of Trustee

Elizabeth Anne Bird
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I. REJECTION OF TRUST

§4.1 A. Named Trustee May Decline to Serve

The trustee named in the trust instrument, whether the original trustee or a successor, is not obliged to serve. In the language of Prob C §15601, a named trustee who does not consent to serve as trustee has "rejected the trust." This "rejection" does not affect the validity of the trust, but it creates a vacancy in the office of trustee and a new trustee must be found to administer the trust. Procedures for filling a vacant trustee position are discussed in §§4.39-4.44.

Probate Code §§15600-15601 require the named trustee to take affirmative action—to sign the trust instrument or a separate written acceptance, or to act knowingly under the trust in a nonemergency—to accept the trust. Rejection may be express or may be by failure to accept. California cases under former law held that a named trustee could decline as a matter of right. See *McCarthy v Poulsen* (1985) 173 CA3d 1212, 219 CR 375; *Estate of Tourny* (1957) 154 CA2d 501, 316 P2d 763 (named trustee will not be presumed to have accepted when not necessary to trust).

A named trustee must reject before accepting appointment or exercising powers or performing duties under the trust instrument (except when actions are necessary to prevent damage to the trust property). See Prob C §15600. When the person named as trustee does not accept the trust by a method provided in Prob C §15600(a) within a "reasonable time" after learning of being named as trustee, the trustee is deemed to have rejected the trust. Prob C §15601(b).

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§4.2 B. Timing of Rejection

The named trustee should carefully consider, immediately on notification, whether he or she wants to serve. The attorney for the trustee should explain all the duties and obligations of acting as trustee so that the named person can make an informed decision. A named trustee who does not wish to serve should be sure to reject the trust before accepting the appointment. One who accepts the appointment, and then chooses not to serve, can no longer reject the trust, but must resign. See Prob C §15640. Procedures for resignation are discussed in §§4.8-4.17.

PRACTICE TIP: Review with a prospective individual trustee all the duties and obligations, including the need to keep good records, keep beneficiaries informed, provide beneficiaries with periodic reports and accountings of trust administration, keep assets properly invested, consider beneficiaries' current and future needs, tax positions, and conflicts of interest, prepare and file trust tax returns, make estimated quarterly payments, review bills, pay property taxes, determine whether appropriate insurance coverage is in place, and so forth. Review the issues of the proposed trustee's individual liability for breaches of trust. Consider whether a corporate trustee or private, professional trustee might be better equipped to administer the trust. See also §4.48.

PRACTICE TIP: The practitioner should take particular care in advising a potential trustee when the trust assets include property with possible environmental problems. Otherwise, once the trusteeship is accepted, the trustee's name is in the chain of title and the trustee, even if he or she promptly resigns, may be exposed to personal liability regarding environmental issues. The potential trustee might make his or her acceptance contingent on receipt of a Phase I report indicating that there is no perceived hazardous contamination or on receipt of some other type of reassurance from an environmental investigation. See generally chap 6.

An early decision by the named trustee who does not wish to serve also gives fair notice to the settlor, personal representative, beneficiaries, and any resigning trustee that another trustee must be found, which will help prevent a gap in the administration of the trust.

In the case of a testamentary trust, the named trustee need not make a decision until the assets are about to be distributed by either a preliminary or a final distribution. Prob C §15601(b). There may be reasons for waiting to decide whether to act. Before deciding whether he or she can properly administer the trust, the named trustee may wish to know, for example, what assets will actually be distributed to the trust or what outcome will result from litigation or disputes over the trust assets. The named trustee should decide as soon as possible whether to decline appointment, so that another trustee can be found who is willing to accept appointment and who can monitor the estate during probate.

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§4.3 C. Rejection Procedure; Response

The named trustee is under no obligation to give a reason for the rejection. The named trustee of a revocable trust who decides to reject the appointment should promptly advise the settlor and the settlor's attorney in writing. Although Prob C §§15600-15601 do not require a named trustee to reject in writing, it is good practice to do so to prevent misunderstandings. A simple letter should suffice. See §4.4.

It is advisable for the attorney to prepare a form for the declining trustee to sign. This can be added to the trust records to clarify in the future why a named trustee did not act as trustee. A signed declination form, which is added to the trustee records, will prove particularly useful if the settlor is incapacitated or the trust has become irrevocable, or both.

After deciding to reject, the named trustee of a testamentary trust should file a written rejection with the clerk of the court in which the estate proceedings are pending, and give a copy of the rejection to the decedent's personal representative. Prob C §15601. See §4.5 for sample form. Failure to act within a reasonable period of time will be considered a rejection. Prob C §15601(b).

On receipt of the rejection, the decedent's personal representative, the attorney, or the beneficiaries should contact the successor named in the governing instrument. If there is no named successor, the personal representative or the beneficiaries should find another trustee to serve. For discussion of filling vacancies, see §§4.40-4.44.

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Source: Estate Planning/California Trust Administration/4 Rejection of Trust; Resignation and Removal of Trustee/§4.4 1. Form: Letter Declining to Serve as Trustee

§4.4 1. Form: Letter Declining to Serve as Trustee

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Dear _ _[*name of settlor or settlor's attorney*]_ _**,**

_ _[*I/Name of bank or institution*]_ _ _ _[*am/is*]_ _ **named as trustee of the** _ _[*name of trust*]_ _**.**

This is to inform you that _ _[*I/name of bank or institution*]_ _ **decline(s) to accept the position as trustee of the** _ _[*name*]_ _ **trust.**

Please acknowledge receipt of this letter by signing and returning the enclosed copy.

Dated: _ _ _ _ _ _ __[*Signature*]__
_ _[*Title*]_ _
_ _[*Name of bank or institution*]_ _

(notary)

Receipt acknowledged:

Dated: _ _ _ _ _ _ __[*Signature*]__

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Source: Estate Planning/California Trust Administration/4 Rejection of Trust; Resignation and Removal of Trustee/§4.5 2. Form: Formal Declination to Serve as Trustee of Testamentary Trust

§4.5 2. Form: Formal Declination to Serve as Trustee of Testamentary Trust

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

Trust created under the Will of _ _[*name of decedent*]**_ _, deceased**

No. _ _ _ _ _ _
REJECTION OF TRUST

[*Add one of the following alternatives*]

[*Alternative 1*]

I, the undersigned, am named as Trustee of the _ _[*name*]**_ _ Trust created under the Will of _ _**[*name*]**_ _. I hereby decline to serve.**

[*Alternative 2*]

I, the undersigned, state that I am _ _[*title of person*]**_ _ of the _ _**[*name of bank or institution*]**_ _, which is named as Trustee of the _ _**[*name*]**_ _ Trust created under the Will of _ _**[*name*]**_ _, and _ _**[*name of bank or institution*]**_ _ hereby declines to serve.**

[*Continue*]

Date: _ _ _ _ _ _ __[*Signature*]__

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II. RESIGNATION OF TRUSTEE

§4.6 A. Reasons for Resignation

Often the trustee chosen by the settlor or the testator will not remain in office for the duration of the trust. A vacancy in the office of trustee most often occurs when an individual trustee dies. Individual trustees may choose to resign for a variety of reasons. For example, the trustee may no longer have time to spend on the trust's affairs; may move from the place where the trust is administered, or where the beneficiaries reside, or where the assets are located; may no longer have the mental or physical ability to manage the affairs of the trust properly; or simply may no longer wish to administer the trust.

A corporate trustee may resign because, *e.g.,* an increased fee schedule makes it uneconomical to manage the trust; the principal of the trust estate has decreased or responsibilities have increased so that the trustee cannot adequately be compensated; or it may go out of the trust business altogether. Usually, the trustee will send a letter to the beneficiaries stating the reasons for resignation and explaining the procedure for court approval, if applicable. See §4.7.

Either an individual or a corporate trustee may resign when there is a conflict of interest with the trust beneficiaries or between two trusts that have differing interests. Prob C §16005; see chap 2 on conflicts of interest. The trustee cannot be compelled to remain as trustee. See Prob C §15640(d); *McCarthy v Poulsen* (1985) 173 CA3d 1212, 1217, 219 CR 375.

NOTE: The trustee's resignation does not release or affect the liability for acts or omissions of either a resigning trustee or the sureties on the trustee's bond, if any. Prob C §15641. The trustee, therefore, may wish to consider obtaining court approval of his or her accounts. See chap 7.

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Source: Estate Planning/California Trust Administration/4 Rejection of Trust; Resignation and Removal of Trustee/§4.7 B. Letter of Resignation to Beneficiaries

§4.7 B. Letter of Resignation to Beneficiaries

Whether or not court approval is required, it is good practice for the trustee to write the beneficiaries to tell them of the intended resignation, why the trustee wishes to resign, the procedures that will be followed, and the timing of these procedures. The letter should also identify the successor trustee named in the trust instrument or the procedure set out for selecting one. If neither is covered by the trust instrument and consent to the resignation cannot be obtained as required under Prob C §15640(b) or (c), the letter should explain the procedure for petitioning the court under Prob C §§15640(d) and 17200. See §§4.8-4.17. It is recommended practice to send the beneficiaries the petition even though the statute requires that only notice of the petition, and not the petition itself, be given to the beneficiaries. Prob C §17203. For sample letter, see §4.18.

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C. Resignation Procedure

§4.8 1. As Provided in Trust Instrument

A trustee may resign as provided in the trust instrument. Prob C §15640(a); Restatement (Third) of Trusts §36(a) (2003). The first step is to examine the trust instrument to determine whether it contains a provision allowing the trustee to resign and, if so, whether it requires any special procedures or contains any restrictions on resignation.

Often the trust instrument allows the trustee to resign, either unconditionally (see California Will Drafting §28.19 (3d ed Cal CEB 1992)) or after a period of notice to the beneficiaries. Usually the trust instrument requires giving notice only to income beneficiaries, on the reasoning that giving notice to all beneficiaries, including contingent remainder beneficiaries, would be burdensome, expensive, and in some cases impossible. The successor trustee or a continuing cotrustee must give notice of a change of trustee to the income beneficiaries. Prob C §16061.7(a). See §§2.7-2.12. A trust instrument may also prescribe a specific manner for giving notice, such as by registered or certified mail.

The trustee must exercise the right to resign in good faith and in accordance with fiduciary principles. See *Vale v Union Bank* (1979) 88 CA3d 330, 151 CR 784, in which a bank trustee was held liable for the loss from forced liquidation of the bank's common trust funds when it resigned in accordance with the trust instrument, because of its unwillingness to follow the administrative committee's investment directions as required by the terms of the trust instrument.

Problems may arise in unsupervised trusts (see chap 15) that give the trustee the power to resign but fail to provide complete procedures for resignation, such as the length of notice, the method of giving notice, or the persons to whom notice should be given. In such a case, the trustee's attorney can either

- Petition the court for instructions about the proper method to resign (on petition for instructions, see §15.26);
- Obtain the consent of the beneficiaries (Prob C §15640(c)) or persons holding a power of revocation (Prob C §15640(b)); or
- Petition for resignation under Prob C §15640(d).

If the trust is subject to continuing court supervision, the trustee must obtain court approval before the resignation is effective. The procedure in Prob C §§17200-17211 is required even if the trust instrument allows resignation.

PRACTICE TIP: No matter what procedure is authorized for a trustee who wishes to resign, the trustee may also petition under Prob C §§15640(d) and 17200(b)(11). For a sample petition, see §4.14.

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§4.9 2. Trust Silent: Methods of Resignation

When the trust is silent about resignation, the trustee has the choice of resigning with the consent of certain classes of people (see §§4.10-4.11) or petitioning the court for approval and appointment of a successor trustee (Prob C §§15640(d), 17200(b)(11)). The court must accept the resignation. Prob C §15640(d). If a successor trustee cannot be found, the court must nonetheless accept the resignation and appoint a receiver. See *McCarthy v Poulsen* (1985) 173 CA3d 1212, 219 CR 375.

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§4.10 a. Irrevocable Trusts: Consent of Beneficiaries or Court Approval

Trustees of irrevocable trusts that are silent regarding resignation must either obtain the beneficiary consents required under Prob C §15640(c) or petition the court to resign under Prob C §§15640(d) and 17200(b)(11). For sample court petition, see §4.14.

The trustee of an irrevocable trust can resign by obtaining the consent of all adult beneficiaries who are receiving or are entitled to receive income or who would receive principal if the trust were then terminated. Prob C §15640(c). If a beneficiary has a conservator, the conservator may consent to the trustee's resignation on the conservatee's behalf without obtaining court approval. If a beneficiary has designated an attorney-in-fact who has the power under the power of attorney to consent to the trustee's resignation, the attorney-in-fact may consent to the resignation. Prob C §15640(c).

No formalities are required, but caution would suggest that the trustee obtain the consents in writing even though the statute does not require it. Because the process of obtaining all of the required beneficiary consents is usually cumbersome and problematic, this method of resignation is rarely used.

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§4.11 b. Revocable Trusts: Consent of Power Holder or Court Approval

The trustee of a revocable trust can resign by obtaining the consent of the person holding the power to revoke the trust. Prob C §15640(b). No special form of consent is required, but a writing would seem wise. The trustee may also petition the court to resign. Prob C §§15640(d), 17200(b)(11). See §4.14 for a sample petition.

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§4.12 c. Court Approval of Resignation

A trustee may petition the court for acceptance of his or her resignation under Prob C §§15640(d) and 17200(b)(11). Probate Code §15640(d), by its use of the word "shall," requires the court to accept the trustee's resignation. This section and Prob C §17206 authorize the court to make any order necessary to preserve the trust estate, including appointment of a temporary trustee or a receiver. However, the court may not condition its approval on the appointment of a successor. See *McCarthy v Poulsen* (1985) 173 CA3d 1212, 1217, 219 CR 375.

The trustee has a duty not to unreasonably injure the beneficiaries by reason of a resignation (*Vale v Union Bank* (1979) 88 CA3d 330, 151 CR 784), so efforts should be made to find a successor or to time the effective date of a resignation to the appointment of a successor. It may be difficult to find a successor if the trust corpus is too small to interest a corporate fiduciary and if there are no capable or consenting family members or friends to take over. In this event, the trustee or a beneficiary should consider termination of the trust on the ground that the corpus is so small that continued administration is not economical. See chap 16.

PRACTICE TIP: The practitioner should consider whether the court will allow a successor trustee who is not named in the instrument and who is not a corporate fiduciary to serve without bond on a waiver of all adult beneficiaries. See discussion of bond and the issue of who are "all adult beneficiaries" in §4.44. Any proposed waiver of bond should be included in the nomination and added to the sample nomination form in §4.15, and the waiver of or imposition of the bond should also be included in the sample order form in §4.17. It is best to check local rules before filing the petition.

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Source: Estate Planning/California Trust Administration/4 Rejection of Trust; Resignation and Removal of Trustee/§4.13 (1) Content of Petition for Approval of Resignation; Notice of Hearing

§4.13 (1) Content of Petition for Approval of Resignation; Notice of Hearing

The procedure for all Prob C §17200 petitions, including resignation, is discussed in chap 15. The code sections do not set out requirements for the contents of a petition for resignation. However, a practical solution is to include in the petition the names and addresses of all living beneficiaries and other interested persons known to the resigning trustee, as required by Prob C §17201, and to state whether a guardian ad litem should be appointed. The petition should describe any unusual circumstances that the beneficiaries or the court may need to know about to protect the trust estate. See §4.14 for sample form.

The resigning trustee must send notice, at least 30 days before the time set for the hearing on the petition, to all other trustees and all beneficiaries who are entitled to notice (Prob C §§15802-15804) and to the Attorney General if a charitable trust subject to the jurisdiction of the Attorney General is involved. Prob C §17203(a). In addition, notice must be given to any person, other than a trustee or beneficiary, whose right, title, or interest would be affected by the petition and who does not receive notice under Prob C §17203(a). Prob C §17203(b). In the case of deceased beneficiaries, notice must be given to the personal representative, heir, devisee, or named executor of the beneficiary and to any guardian or conservator of the decedent at the time of the decedent's death. Prob C §17203(c).

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§4.14 (2) Form: Petition for Order Accepting Resignation of Trustee and for Appointment of Successor Trustee

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

Trust created under the Will of _ _[*name of decedent*]_ _, deceased [*Or*] **Trust created by agreement dated _ _[*date*]_ _, by _ _[*name*]_ _**	**No. _ _ _ _ _ _** **PETITION FOR ORDER ACCEPTING RESIGNATION OF TRUSTEE AND FOR APPOINTMENT OF SUCCESSOR TRUSTEE (PROB C §15640)** **Hearing Date: _ _[*date*]_ _** **Time: _ _[*time*]_ _** **Dep't: _ _[*number*]_ _** **Judge: _ _[*if known*]_ _**

The petition of _ _[*name of trustee*]_ _, as Trustee of the _ _[*name*]_ _ Trust, alleges that:

1. Petitioner

[*Add one of the following alternatives*]

[*Alternative 1*]

was appointed Trustee under the will of _ _[*name*]_ _ by Order of Court dated _ _[*date*]_ _, and ever since has been and now is the duly appointed, qualified, and acting Trustee of said trust.

[*Alternative 2*]

accepted trusteeship of the _ _[*name*]_ _ trust created by the Trust Agreement dated _ _[*date*]_ _, and has been acting as Trustee since that date.

[*Continue*]

2. Petitioner hereby resigns as Trustee of the _ _[*name*]_ _ Trust.

[*Add one of the following alternatives*]

[*Alternative 1*]

3. _ _[*Name of institution*]_ _ is named as Successor Trustee of this Trust under Paragraph _ _ of the trust instrument. Attached as Exhibit A and incorporated by reference is the consent of _ _[*name of successor trustee*]_ _ to _ _[*his/her*]_ _ appointment as Successor Trustee of this Trust. The named successor is a resident of the State of _ _ _ _ _ _ and is over the age of eighteen years.

[*Or*]

3. _ _[*Name*]_ _ is named as Successor Trustee of this Trust under Paragraph _ _ of the trust instrument. Attached as Exhibit A and incorporated by reference is the consent of _ _[*name*]_ _ as _ _[*title*]_ _ and on behalf of _ _[*name of institution*]_ _. The named successor is _ _[*e.g., a trust company doing business in California*]_ _.

[*Alternative 2*]

3. Paragraph _ _ of the trust instrument grants _ _[*name*]_ _ the power to nominate a successor trustee and _ _[*he/she/it*]_ _ has nominated _ _[*name*]_ _. Petitioner alleges on information and belief that this nomination and nominee's acceptance will be filed with the Court by the time of the hearing on this petition for resignation.

[*Alternative 3*]

3. There is no provision in the trust instrument for appointment of a successor trustee. Petitioner alleges on information and belief that the beneficiaries of the Trust will file a nomination and nominee's acceptance with the Court by the time of the hearing on this petition for resignation.

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Trust instrument waives bond*]

4. No bond should be required because the trust instrument waives bond.

[*Alternative 2: Beneficiaries waive bond*]

[*If applicable, add one of the following alternatives*]

[*Alternative 2a: Nominators of successor trustee waive bond*]

4. Petitioner alleges on information and belief that no bond should be required because the nominators of the successor trustee will include in their nomination a waiver of bond.

[*Alternative 2b: All beneficiaries waive bond*]

4. All adult _ _[*income and remainder*]_ _ beneficiaries of the trust waive the requirement of bond.

[*Alternative 3: Bond required*]

4. Bond should be fixed in the amount of _ _[*state amount*]_ _ to be furnished by an authorized surety company or as otherwise provided by law.

[*Continue*]

5. Under Probate Code §§15640(d) and 17200(b)(11), Petitioner alleges that this Court has jurisdiction to and must under the statute accept the resignation of _ _[*name*]_ _ as Trustee. Therefore Petitioner requests that the resignation of Petitioner be accepted, and that _ _[*name*]_ _ be appointed as Successor Trustee.

6. The names and last known post office addresses of the beneficiaries of the Trust and all other persons who may be entitled to notice under Probate Code §17203, as far as known to Petitioner, are: _ _[*Insert names and addresses*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1*]

7. No one has filed a request for special notice in this proceeding.

[*Alternative 2*]

7. The following have filed request(s) for special notice in this proceeding: _ _[*Insert names*]_ _.

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: If filing accounting*]

8. Petitioner, as Trustee, hereby incorporates as Exhibit B, attached hereto, the accounting of _ _[*his/her/its*]_ _ acts as Trustee from _ _[*date*]_ _, through _ _[*date*]_ _.

[*Alternative 2: If not filing accounting*]

8. Petitioner, as Trustee, has faithfully managed and conducted the Trust since _ _[*his/her/its*]_ _ appointment

as Trustee in strict accordance with the terms of the Trust. Although Petitioner has periodically presented the income beneficiar_ _[*y/ies*]_ _ _ _[*and remainder beneficiar_ _[*y/ies*]_ _]_ _ with statements of account, no formal accounting has been filed. Petitioner believes the expense of preparing such an accounting would not be in the best interests of the Trust or of the beneficiaries.

[*Continue*]

[*If trust is court-supervised*]

[*Waiver of accounting*]

[9.] All beneficiaries of the trust waive accounting. Attached hereto and incorporated by reference _ _[*is/are*]_ _ the waiver(s) of accounting signed by _ _[*name(s)*]_ _.

[*Continue*]

[*If trust is court-supervised*]

[*Compensation for petitioner's services*]

[10.] Petitioner has rendered services described as follows: _ _[*Description of services*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1*]

Petitioner has received no compensation and asks for $_ _[*dollar amount*]_ _ as reasonable compensation for such services.

[*Alternative 2*]

Petitioner asks for $_ _[*dollar amount*]_ _ as reasonable compensation for such services, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income, of which $_ _[*dollar amount*]_ _ has already been paid.

[*Continue*]

[*If trust is court-supervised*]

[*Costs and expenses for transfer of trust assets*]

[11.] Petitioner will incur reasonable costs and expenses in delivering the trust assets to the Successor Trustee or receiver and asks that these expenses be allowed in an amount not to exceed $_ _[*dollar amount*]_ _, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income.

[*If trust is court-supervised*]

[*Compensation for attorney's services*]

[12.] Petitioner's attorney, _ _[*name*]_ _, has rendered services to Petitioner described as follows: _ _[*Description of services*]_ _. Petitioner has paid the attorney no compensation for _ _[*his/her*]_ _ services and requests that Petitioner be authorized to pay the attorney reasonable fees in the sum of $_ _[*dollar amount*]_ _ for these services, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income.

[*For both court-supervised and unsupervised trusts*]

[*Continue*]

[13.] Petitioner requests the Court to authorize Petitioner to transfer the assets of the Trust remaining on hand to the Successor Trustee when the latter has been appointed.

[*For unsupervised trusts only*]

[14.] A copy of the trust instrument dated _ _[*date*]_ _, is attached as Exhibit _ _.

[*For both court-supervised and unsupervised trusts*]

[*Continue*]

WHEREFORE, PETITIONER REQUESTS that:

1. The Court accept Petitioner's tender of resignation.

[*If trust is court-supervised*]

2. The Court approve payment to Trustee in the amount of $_ _[*dollar amount*]_ _ for services rendered in the administration of the Trust, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income.

[*If trust is court-supervised, and costs and expenses have been requested*]

[3.] The Court allow Petitioner _ _[*his/her/its*]_ _ reasonable costs and expenses not to exceed $_ _[*dollar amount*]_ _ to be incurred in the delivery and transfer of the trust assets to _ _[*his/her/its*]_ _ Successor Trustee, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income.

[*If trust is court-supervised*]

[4.] The Court authorize and direct Petitioner to pay fees in the amount of $_ _[*dollar amount*]_ _ to _ _[*his/her/its*]_ _ attorney(s), for the services set forth above.

[*If trust is court-supervised*]

[5.] The Court _ _[*approve the accounting/accept the waiver of accounting*]_ _ and discharge and release Petitioner as Trustee _ _[*for the period of the accounting*]_ _ on delivery and transfer of all the trust assets to _ _[*his/her/its*]_ _ Successor Trustee and the filing of a receipt with the Court.

[*If trust is not court-supervised*]

[2.] The Court direct Petitioner to distribute the remaining trust assets, after payment of trustee's and attorneys' fees and costs, to _ _[*name*]_ _ as Successor Trustee.

[3.] The Court appoint _ _[*name*]_ _ as Successor Trustee to serve _ _[*without bond/on providing the Court with evidence that a bond in the amount of _ _[state amount]_ _ has been obtained*]_ _.

[*For both court-supervised and unsupervised trusts*]

[*Continue*]

[_.] For all further and proper orders, including any Order the Court may deem necessary for the preservation of the Trust.

Date: _ _ _ _ _ _

__[*Signature of trustee*]__
Trustee

__[*Signature of attorney for petitioner*]__
Attorney for Petitioner

[*Verification; see §7.116*]

Comment: The petitioner is not required by statute to ask for trustee or attorney fees in the petition if the trust is unsupervised. Some practitioners believe the approval of fees will protect the trustee from later attacks by beneficiaries or the successor trustee. If there appear to be potential problems, it may be prudent to seek approval in the petition. Also, local rules should be consulted.

PRACTICE TIP: If the public guardian or administrator would not be a good choice to act as successor trustee, it is important to file a consent by an individual or corporate fiduciary willing to serve as trustee. The court may not appoint the public guardian or administrator without the consent of the official unless it finds, based on reasonable inquiry, that no other qualified person is willing to act as trustee. Prob C §15660.5. See §9.19.

See §4.44 on bond requirements and the question of who are considered "all adult beneficiaries."

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§4.15 (3) Form: Nomination of Successor Trustee

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[*Caption; see §4.14*] **No. _ _ _ _ _ _**

NOMINATION OF SUCCESSOR TRUSTEE

I, _ _[*name of beneficiary***]_ _, as _ _[***income/remainder***]_ _ beneficiary of the _ _[***name***]_ _ Trust dated _ _[***date***]_ _, created by _ _[***name of settlor***]_ _, hereby nominate _ _[***name of successor trustee***]_ _ to serve without bond as Successor Trustee of the Trust on appointment by the Court.**

Date: _ _ _ _ _ _ __[*Signature*]__

Comment: See Practice Tip in §4.12 regarding waiver of bond.

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§4.16 (4) Form: Consent to Act as Successor Trustee

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[*Caption; see §4.14*] **No. _ _ _ _ _ _**
CONSENT TO ACT AS SUCCESSOR TRUSTEE

I, _ _[*name of successor trustee*]_ _, hereby accept appointment to serve as Successor Trustee of the _ _[*name*]_ _ Trust dated _ _[*date*]_ _, created by _ _[*name of settlor*]_ _, effective on Court order accepting resignation of _ _[*name of trustee*]_ _ as Trustee and appointing me as Successor Trustee.

Date: _ _ _ _ _ _ __[*Signature of successor trustee*]__

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§4.17 (5) Form: Order Accepting Resignation of Trustee and for Appointment of Successor Trustee

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[*Caption; see §4.14*]

No. _ _ _ _ _ _
ORDER ACCEPTING RESIGNATION OF TRUSTEE AND FOR APPOINTMENT OF SUCCESSOR TRUSTEE

The verified petition of _ _[*name of trustee*]_ _, as Trustee of the _ _[*name*]_ _ Trust dated _ _[*date*]_ _, for Order Accepting Resignation of Trustee and for Appointment of Successor Trustee

[*If trust is court-supervised*]

, and for approval of trustee's and attorneys' fees and costs,

[*Continue*]

was duly presented to the Court.

On proof made to the satisfaction of the Court, the Court finds that all notices of hearing have been given as required by law and that the allegations in the petition are true;

[*If trust is court-supervised*]

that trustee's compensation requested in the Petition is reasonable and is allowed in the amount of $_ _[*dollar amount*]_ _, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income; that costs and expenses in delivering the trust assets to the Successor Trustee are allowed in the amount of $_ _[*dollar amount*]_ _, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income; that attorneys' fees for the services of _ _[*name*]_ _ requested in the Petition are reasonable and are allowed in the amount of $_ _[*dollar amount*]_ _, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income;

[*Continue*]

that all notices of hearing have been given as required by law; and that, good cause appearing, the Court grants the Petition as follows:

IT IS ORDERED that:

1. Petitioner's tender of resignation is accepted.

[*If trust is court-supervised*]

[*Either*]

2. Petitioner's accounting, setting forth _ _[*his/her/its*]_ _ acts from _ _[*date*]_ _, to _ _[*date*]_ _, is approved.

[*Or*]

2. Waivers of accounting from all the beneficiaries have been filed with the Court, and no accounting need be filed.

[*If trust is not court-supervised*]

2. Petitioner's resignation shall be effective on the transfer to _ _[*name of successor trustee*]_ _ as Successor

Trustee, after payment of trustee's and attorneys' fees and costs, of all remaining assets of the Trust.

[*If trust is court-supervised*]

3. _ _[*Name of trustee*]_ _, as Trustee, is entitled to compensation for services in the amount of $_ _[*dollar amount*]_ _, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income, and for reimbursement for costs in the amount of $_ _[*dollar amount*]_ _, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income.

[*If trust is court-supervised*]

4. Petitioner is entitled to reasonable costs and expenses in the amount of $_ _[*dollar amount*]_ _, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income, for the delivery and transfer of the trust assets to the Successor Trustee.

[*If trust is court-supervised*]

5. _ _[*Name of trustee*]_ _, as Trustee of the _ _[*name*]_ _ Trust, is authorized to pay _ _[*his/her/its*]_ _ attorney(s), _ _[*name(s) of attorney(s)*]_ _, the sum of $_ _[*dollar amount*]_ _, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income, as reasonable attorneys' fees for the services described in the petition for resignation.

[*For both supervised and unsupervised trusts*]

6. Trustee's resignation and discharge is to be effective when all remaining assets of the _ _[*name*]_ _ Trust have been transferred to _ _[*name of successor trustee*]_ _ as Successor Trustee and proper receipts have been filed with this Court. The resigning Trustee shall deliver assets to the Successor Trustee within 30 days after issuance of the Order.

[*For both supervised and unsupervised trusts*]

[*Continue*]

[7.]_ _[*Name of successor trustee*]_ _ **is hereby appointed Successor Trustee of the _ _[*name*]_ _ Trust to serve _ _[*without bond/on providing the Court with evidence that a bond in the amount of _ _[state amount*]_ _ *has been obtained*]_ _.**

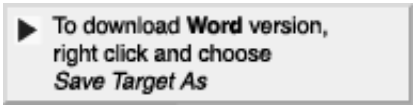
Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

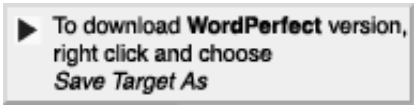
Comment: See Practice Tip in §4.12 regarding waiver of bond.

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Source: Estate Planning/California Trust Administration/4 Rejection of Trust; Resignation and Removal of Trustee/§4.18 D. Form: Letter of Resignation to Beneficiaries

§4.18 D. Form: Letter of Resignation to Beneficiaries





Dear _ _ _ _ _ _,

After careful consideration, I have decided to no longer act as trustee of the _ _[*name*]**_ _ trust.**

[*Optional*]

Because of _ _[*e.g., illness/press of other business*]**_ _, I am resigning as trustee**

[*Add one of the following alternatives*]

[*Alternative 1*]

under paragraph _ _ of the trust instrument, which reads as follows: _ _[*Quote language on resignation from trust instrument*]**_ _.**

[*Alternative 2*]

by petitioning the Superior Court of _ _ _ _ _ _ County under Probate Code §§15640 and 17200. The petition will be filed on _ _[*date*]**_ _, and I hope to have a hearing date by _ _**[*date*]**_ _. You will receive notice of the hearing and may attend if you like, but you need not.**

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1*]

As you know, paragraph _ _ of the trust instrument appoints _ _[*name*]**_ _ as successor trustee of this trust. I have notified _ _**[*him/her/it*]**_ _ of my intention to resign and _ _**[*he/she/it*]**_ _ has advised me of _ _**[*his/her/its*]**_ _ willingness to act as trustee _ _**[*subject to appointment by the Court*]**_ _. I plan to resign in _ _ days on approval of the Court and will begin to turn over the books and records and assets of the trust to the successor as soon as possible.**

[*Alternative 2*]

Because the trust instrument neither names a successor trustee nor provides a procedure for appointment of a successor, it will be necessary to petition the Court for appointment of a successor. _ _[*Name*]**_ _ has agreed to act as trustee. However, you also have the right under Probate Code §15660 to suggest a successor trustee to the Court.**

[*Alternative 3*]

Paragraph _ _ of the trust instrument states that _ _[*name*]**_ _ shall appoint the successor trustee. I have asked _ _**[*name*]**_ _ to appoint a successor within _ _ days so that I can begin to turn over the trust assets.**

[*Continue*]

If you have any questions, please do not hesitate to contact me or my attorney, _ _[*name of attorney*]**_ _.**

Very truly yours,
__[*Signature of trustee*]__

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III. REMOVAL OF TRUSTEE

§4.19 A. Power to Remove Trustee

The trust instrument may grant someone the power to remove the trustee with or without cause. Even without an explicit power to remove, if the trust is subject to unrestricted amendment, the person holding the power to amend will always be able to remove the trustee by simply amending the trust to replace the trustee. See §§16.5-16.9.

The trust instrument may reserve to the settlor the power to remove the trustee. This power is commonly coupled with the power to appoint a successor. The trust instrument may also grant the power to remove the trustee to a cotrustee, beneficiary, or unrelated third party. Additionally, the settlor of an irrevocable trust may petition the court for the removal of a trustee. See Prob C §15642(a); *Patton v Sherwood* (2007) 152 CA4th 339, 61 CR3d 289 (settlor of charitable trust had standing to object to accounts when settlor reserved power to remove and replace trustees and compel accounts); Restatement (Third) of Trusts §37 (2003).

The power to remove the trustee may be exercisable for cause, such as unsatisfactory but not culpable performance, or deterioration of personal relations. If the trust instrument provides this power without limitation, it is exercisable at will. The power, along with the power to appoint a successor, is often granted to a majority of income beneficiaries. For examples of trust clauses allowing removal, see Drafting California Revocable Trusts §§16.35-16.46 (4th ed Cal CEB 2003). The person holding the power to remove the trustee must exercise this power in accordance with any terms and limitations in the trust instrument. However, the court will always have the power to remove the trustee on the petition of a settlor, cotrustee, or beneficiary or on its own motion. Prob C §15642. See §4.21. On suspension of trustee powers, see §15.44A.

NOTE: In Rev Rul 95-58, 1995-2 Cum Bull 191, the Internal Revenue Service ruled that a decedent-grantor's reservation of an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the decedent (within the meaning of IRC §672(c)) is not considered a reservation of the trustee's discretionary powers of distribution over the property transferred by the decedent-grantor to the trust. See also *Estate of Helen S. Wall* (1993) 101 TC 300. Consistent with Rev Rul 95-58, in IRS Letter Ruling 9607008, the IRS ruled that it is permissible to give the power to remove and replace a trustee to a trust beneficiary and that it will not be held to be a general power of appointment.

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B. Removal Procedure

§4.20 1. In Accordance With Trust Instrument

The persons removing the trustee must follow any procedures required by the trust. Prob C §15642(a). The action should be taken or confirmed in writing to properly document trust records. If the person who removes the trustee also has the power to appoint a successor, the writing removing the trustee should also state the name and address of the successor trustee so that there can be an orderly transfer of trust assets and trust records.

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons) and that will have total assets of more than $20,000 after receipt of those funds—the trust instruments must require court approval of changes in trustees and a court order appointing any successor trustee. Cal Rules of Ct 7.903(a)(1), (c)(7), (d) (Probate).

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§4.21 2. Removal by Court

Probate Code §15642(b) allows the court to remove a trustee:

- If the trustee has committed a breach of the trust;
- If the trustee is insolvent or otherwise unfit to administer the trust;
- If hostility or lack of cooperation among cotrustees impairs the administration of the trust;
- If the trustee declines or fails to act;
- If the trustee's compensation is excessive under the circumstances;
- If the sole trustee is a disqualified person under Prob C §21350 and no exception exists under Prob C §15642(b)(6) for allowing the trustee to continue to act;
- If the trustee is substantially unable (as determined under Prob C §§810-813) to manage the trust's financial resources or is otherwise substantially unable to execute properly the duties of the office;
- If the trustee is substantially unable to resist fraud or undue influence; or
- For other good cause.

Examples of good cause include hostility toward a beneficiary that impairs the administration of the trust (*Estate of Gilmaker* (1962) 57 C2d 627, 21 CR 585; *Copley v Copley* (1981) 126 CA3d 248, 288, 178 CR 842); conflicts of interest (*Estate of Feeney* (1983) 139 CA3d 812, 189 CR 84 (petition to remove executor)); conflicts of interest if adverse actions are taken because of them (*Estate of Gilliland* (1977) 73 CA3d 515, 528, 140 CR 795, 802); or conflicts of interest when the trustee has become trustee of another trust adverse to the interest of a beneficiary. See Prob C §16005. For further discussion of reasons for removal, see §§4.22-4.30.

Removal for substantial inability under Prob C §15642(b)(7)-(8) may not be proved solely by isolated incidents of negligence or improvidence when the trustee holds the power to revoke the trust.

There need not be evidence of actual wrongdoing to remove a trustee. The court can remove a trustee, not to inflict a penalty for past action, but to preserve trust assets. *Getty v Getty* (1988) 205 CA3d 134, 139, 252 CR 342. The court also can, in its discretion, appoint a "trustee ad litem" for the sole purpose of handling certain litigation, rather than removing the trustee. 205 CA3d at 141.

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§4.22 3. Reasons for Removal

Beneficiaries seek the removal of a trustee for a variety of reasons. It is important for the attorneys representing the interested parties to identify why the removal is being sought in order to plan a strategy that best serves the client's interest. The issue the court will want addressed is whether the action is in accordance with, or contrary to, the settlor's intent.

PRACTICE TIP: Be aware that a beneficiary may seek the removal of the trustee out of resentment of the very existence of the trust. In such a case, the beneficiary may seek removal of the trustee as a first step toward obtaining control of the trust assets or distributing them free of trust. A trustee may wish to resign rather than fight a disgruntled beneficiary. Nevertheless, the trustee has a fiduciary obligation to protect and defend the trust estate. The trustee could request that the court determine whether a new trustee should be appointed under Prob C §15660. See §4.43. The attorney for the beneficiary will want to explore whether there are changed circumstances that would justify allowing the trust to be terminated. See §§16.36-16.48.

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§4.23 a. Breach of Duty of Loyalty

A primary reason for removal of a trustee by the court is breach of the trustee's duty of loyalty. See Prob C §§16002, 16004. *Jones v Stubbs* (1955) 136 CA2d 490, 288 P2d 939; *Estate of Vokal* (1953) 121 CA2d 252, 263 P2d 64. A trustee may have a conflict of interest with the trust, or may be trustee of two trusts with conflicting interests. Prob C §16005. On conflicts between two trusts, see §2.52.

NOTE: Older California cases held that, if a potential conflict of interest existed at the time the settlor or the testator appointed the trustee, it was presumed that the settlor or the testator knew of and acquiesced in the conflict as it existed at that time. *Estate of Keyston* (1951) 102 CA2d 223, 227 P2d 17, disapproved on other grounds in *Estate of Schloss* (1961) 56 C2d 248, 256, 14 CR 643. Therefore, the court would not remove the trustee for a potential conflict of interest unless the trustee abused his or her position or a conflict existed of which the settlor or the testator was unaware. *Copley v Copley* (1981) 126 CA3d 248, 288, 178 CR 842; *Estate of Gilliland* (1977) 73 CA3d 515, 528, 140 CR 795. It is not clear whether the courts will continue this reasoning under the current Trust Law. For further discussion, see §§2.36-2.53.

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§4.24 b. Breach of Other Fiduciary Duties

A trustee can be removed for committing a breach of other fiduciary duties, such as the duty of care or impartiality. Any breach of a fiduciary duty is a breach of trust. Prob C §15642(b). A trustee may be removed for failure to reasonably inform the beneficiaries about the trust and its administration. Prob C §16060. See, *e.g.*, *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 207, 91 CR2d 716; *Harnedy v Whitty* (2003) 110 CA4th 1333, 2 CR3d 798. But see *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317. A long line of cases establishes that violation of the duty to account (Prob C §16062) can be grounds for removal. See, *e.g.*, *Estate of Jonathan Thompson* (1894) 101 C 349, 35 P 991; *Irvine v Dunham* (1884) 111 US 327, 28 L Ed 444, 4 S Ct 501. See generally chap 2.

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§4.25 c. Lack of Capacity; Inability to Resist Fraud or Undue Influence

A trustee may be removed when he or she is "insolvent or otherwise unfit to administer the trust;" "substantially unable to manage the trust's financial resources or is otherwise substantially unable to execute properly the duties of the office;" or "is substantially unable to resist fraud or undue influence." Prob C §15642(b)(2), (7)-(8). Substantial inability is determined under the Due Process in Competence Determination Act (DPCDA) (Prob C §§810-813). See Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2008). In addition, the trust instrument may provide that the trustee serves only if not incapacitated, and may provide a mechanism for determining incapacity. See Drafting California Revocable Trusts, chap 16 (4th ed Cal CEB 2003). Probate Code §15643(e) provides that the office of trustee is vacated when a conservator is appointed for a trustee's person or estate. A trustee may, however, become incapable of administering the trust even if no conservatorship proceeding has been (or will be) filed. The beneficiaries' recourse then is to petition the court for removal of the trustee on the ground that he or she is unfit to serve or lacks the necessary capacity to manage the trust as determined under DPCDA. See *Katz v Greeninger* (1950) 96 CA2d 245, 249, 215 P2d 121, 124 (court may appoint trustee to replace incompetent trustee). See also *Estate of Bullock* (1968) 264 CA2d 197, 70 CR 239 (beneficiaries may petition for order restraining trustee from penalizing beneficiaries for action to remove trustee for inability to manage trust).

Even a trustee with the requisite capacity may be unable to resist fraud or undue influence. However, in either case, when the trustee holds the power to revoke the trust, substantial inability to manage the trust or to resist fraud or undue influence may not be proved solely by isolated incidents of negligence or improvidence. Prob C §15642(b)(7)-(8).

The power of attorney statutes (see Prob C §§4000-4545) raise the issue of whether a trustee can transfer the office of trustee or the power to administer the trust to another by a durable power of attorney, thus avoiding a removal proceeding or vacancy in the office of trustee. There is no specific case law or statute, but Prob C §16012, which forbids the trustee from transferring the office of trustee or delegating the entire administration, covers the matter. See also California Durable Powers of Attorney (Cal CEB 1996). For general discussion of delegation, see §§2.33-2.34.

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§4.26 d. Hostility Between Trustee and Beneficiary

A trustee may be removed because of hostility with the beneficiaries, if the hostility impairs the proper and impartial administration of the trust. *Estate of Gilmaker* (1962) 57 C2d 627, 21 CR 585; *Overell v Overell* (1926) 78 CA 251, 248 P 310. In *Gilmaker,* however, the trustee was also in breach of his duty to comply with the terms of the trust instrument. There has been no recent case in which hostility has been the sole reason for removal of the trustee, but there are several earlier cases: *May v May* (1897) 167 US 310, 42 L Ed 179, 17 S Ct 824 (trustee removed when complete breakdown in communication occurred); *Brown v Memorial Nat'l Home Found.* (1958) 162 CA2d 513, 534, 329 P2d 118, superseded by statute on other grounds as stated in *Patton v Sherwood* (2007) 152 CA4th 339, 61 CR3d 289 (trustee removed because of hostility after trustee ceased to hold religious beliefs that trust promoted; holding implied that pure hostility is sufficient for removal).

In *Copley v Copley* (1981) 126 CA3d 248, 178 CR 842, a more recent case, the court held that hostility anticipated by the testator would not be a ground for removal when the proper administration of the trust was not impaired. See also *Goto v Goto* (1960) 187 CA2d 603, 10 CR 20, an earlier case in which the court did not remove the trustee for hostility toward the beneficiary when there was no wrongdoing and when there was no occasion for active administration of the trust. These cases leave open the possibility of removal when the trustee's hostility affects the trustee's exercise of discretion. When the hostility is caused by the beneficiary's demand that the trustee resign, and the trust is not impaired, removal may be refused. *IFS Indus. v Stephens* (1984) 159 CA3d 740, 205 CR 915.

NOTE: There is no authority holding that hostility between a trustee and the attorney representing the trust is a ground for removal of the trustee, presumably because the attorney is employed by the trustee and serves at the trustee's pleasure. Such hostility can arise when the attorney is more closely aligned with the beneficiaries who are in disagreement with the trustee's actions, or when the attorney personally disagrees with the trustee's actions. For discussion of the role of the trustee's attorney, see chap 1. The proper solution to the problem of trustee-attorney hostility would be for the attorney to resign or for the trustee to discharge the attorney. In either situation, a substitution of counsel should be filed in court-supervised trusts. In nonsupervised trusts, the discharge or resignation should be put in writing for the trust records and in order to avoid later misunderstandings. For discussion of substitution of attorneys and a form for that purpose, see California Civil Procedure Before Trial §§4.5-4.14, 4.55 (4th ed Cal CEB 2004).

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§4.27 e. Hostility Between Cotrustees

Hostility between two or more cotrustees that results in disagreement on trust matters can bring administration of the trust to a halt because, absent language to the contrary in the trust instrument, cotrustees must act unanimously (Prob C §15620; see §§3.2-3.3). Prob C §15642(b)(3).

The impasse may be resolved by a petition to the court by any trustee under Prob C §17200. However, frequent petitions are cumbersome and costly. Any trustee or a beneficiary may decide to petition for removal of one or all of the trustees. Also, the court may do so on its own motion, although it will not usually be aware of any problem unless frequent petitions are filed. Under Prob C §15642(b)(3), the court may remove any or all of the trustees and appoint new ones if it believes that hostility, ill feeling, or continued lack of cooperation among the trustees has impaired proper administration of the trust.

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§4.28 f. Disqualified Person

When the sole trustee is a person described in Prob C §21350, whether or not the person is a beneficiary of the trust, that person may be removed by the court on its own motion or on petition of a beneficiary, unless the court finds that the appointment of the disqualified person is consistent with the settlor's intent and that the intent was not the product of fraud, menace, duress, or undue influence. Prob C §15642(b)(6). The provision cannot be waived by the settlor. It does not apply in those situations in which: (1) the settlor is related in specified ways to the disqualified person (Prob C §15642(b)(6)(A)); (2) the instrument is reviewed by an independent attorney who performs certain specified functions (Prob C §15642(b)(6)(B)); or (3) after full disclosure of the relationship of the persons involved, the instrument is approved under a court order (Prob C §15642(b)(6)(C)). For example, the provision does not apply if the settlor is related by blood or marriage to the trustee. In *Estate of Pryor* (2009) 177 CA4th 1466, 99 CR3d 895, the court held that there was no exception to the statutory exemption from the disqualified-transferee provisions in Prob C §21351 for spouses who married after one of the parties became a care custodian of the other. The same reasoning would appear to apply to the statutory exemption from the sole-trustee provisions in Prob C §15642(b)(6)(A).

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§4.29 g. Changed Circumstances

A beneficiary may assert, under Prob C §15409, that the serving trustee was chosen for reasons that no longer exist and that, due to changed circumstances unknown to the settlor and unanticipated by the settlor, the continuation of the trust with the acting trustee would defeat or substantially impair the accomplishment of the purposes of the trust. On this basis, the beneficiary may petition for removal or replacement of the trustee.

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§4.30 h. Trust With Uneconomically Low Principal

A beneficiary or a trustee may assert, under Prob C §15408, that the trustee should be removed or replaced because the current value of the trust estate no longer justifies administration by the sophisticated and expensive trustee chosen by the settlor.

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§4.31 4. Request for Attorney Fees

There is no statutory authority for the court to order payment of a beneficiary's attorney fees from the trust, but such fees can be requested in the petition for removal on the theory that the actions of the beneficiary's attorney have conferred an economic benefit on the trust. *Hutchinson v Gertsch* (1979) 97 CA3d 605, 159 CR 40. See §9.54.

If the court determines that the designation of the trustee was inconsistent with the settlor's intent or was produced by fraud, menace, duress, or undue influence, it can order the trustee being removed to pay attorney fees. Prob C §15642(c). If it finds that the petition for removal of the trustee was filed in bad faith or would be contrary to the settlor's intent, it can order the person or persons seeking removal to pay attorney fees. Prob C §15642(d).

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5. Petition for Removal

§4.32 a. Who May Petition

Removal of a trustee is governed by Prob C §15642. The petition for removal may be filed by a settlor, beneficiary (defined by Prob C §24 as including contingent beneficiaries), or cotrustee. Prob C §15642(a). It is not necessary that all the trust beneficiaries be joined. *Bowles v Superior Court* (1955) 44 C2d 574, 283 P2d 704. Note that, unless the trust provides otherwise, while the trust is revocable and the person holding the power to revoke the trust is competent, the person holding the power (and not the beneficiaries) has the power to seek removal. Prob C §§15800, 17200.

NOTE: Probate Code §15602(a)(3) provides that successor individual trustees not named in the trust instrument are required to be bonded, but the trust instrument may override this requirement by specific reference to successor trustees.

Even if a bond is required by the trust instrument, the court can excuse the requirement of a bond, reduce or increase the amount of a bond, release a surety, or permit the substitution of another bond with the same or different sureties. Prob C §15602(b). In addition, even if a bond is required by the trust instrument, bond may be waived by all adult beneficiaries when an individual not named in the trust instrument is appointed as a trustee by the court. Prob C §15602(b). See §4.44 on bond for the trustee.

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§4.33 b. Venue; Notice

The procedure for filing the petition to remove the trustee appears in Prob C §§17200-17211. Venue is governed by Prob C §17005. Notice of hearing is prescribed by Prob C §17203, which requires notice to be mailed at least 30 days before the time of hearing. See Prob C §§17101-17107 for additional notice provisions. See also Prob C §§1045 (continuance or postponement); 1200, 17100 (general notice provisions); 1203 (order shortening time for giving notice); 1205 (notice of continued or postponed hearing); 1212 (procedure for giving notice where address unknown); 1216 (personal delivery instead of mailing); 1260 (proof of giving notice); 17105 (notice to persons interested in trust without court order).

The petitioner must mail a copy of the notice of hearing to all trustees, to beneficiaries entitled to notice (Prob C §15804), to the person holding the power to revoke (Prob C §15802), and to beneficiaries and creditors of the trust or trustor who have requested notice under Prob C §17204. Under the Trust Law, if a part of the property has yet to be distributed, the personal representative is no longer entitled to notice as was true under former Prob C §1123.5, but it would be good practice to send notice in any event.

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§4.34 c. Form: Petition of Beneficiary to Remove Trustee

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

Trust created under the Will of _ _[*name of decedent*]_ _, deceased	**No. _ _ _ _ _ _** **PETITION OF BENEFICIARY TO REMOVE TRUSTEE AND TO APPOINT SUCCESSOR TRUSTEE AND FOR PAYMENT OF ATTORNEYS' FEES (PROB C §§15642, 17200)** **Hearing Date: _ _[*date*]_ _** **Time: _ _[*time*]_ _** **Dep't: _ _[*number*]_ _** **Judge: _ _[*if known*]_ _**

_ _[*Name*]_ _, as beneficiary of the _ _[*name*]_ _ Trust, alleges:

1. _ _[*Name*]_ _ was appointed Trustee under the Will of _ _[*name*]_ _ by decree of Court dated _ _[*date*]_ _, and ever since has been and now is said Trustee. A true and correct copy of the Trust is attached as Exhibit A and is incorporated by reference into the Petition.

2. _ _[*Name*]_ _ is a beneficiary of said _ _[*name*]_ _ Trust.

3. Beneficiary requests the Court to remove the Trustee pursuant to its authority under Probate Code §15642 because _ _[*state reason, e.g., the trustee is substantially unable to manage the trust's financial resources or is otherwise substantially unable to execute properly the duties of the office; the trustee breached its fiduciary duty to reasonably inform beneficiaries and/or to account; the trustee is substantially unable to resist fraud or undue influence (add details)*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1*]

4. Beneficiary requests that the Court appoint _ _[*name of successor trustee*]_ _ as Successor Trustee as set forth in paragraph _ _ of the decree of distribution creating said Trust. The beneficiary further requests that the Court appoint said Successor Trustee _ _[*with/without bond*]_ _.

[*Alternative 2*]

4. Paragraph _ _ of the trust instrument appoints _ _[*name of successor trustee*]_ _ as Successor Trustee. _ _[*Name*]_ _ has declined to serve and such declination is attached as Exhibit B. Beneficiary requests that the Court appoint _ _[*name*]_ _ as Successor Trustee. _ _[*Name*]_ _'s consent to serve is attached as Exhibit C. The beneficiary further requests that the Court appoint said Successor Trustee _ _[*with/without bond*]_ _.

[*Alternative 3*]

4. The trust instrument does not appoint a Successor Trustee. Beneficiary requests that the Court appoint _ _[*name*]_ _ as Successor Trustee. _ _[*Name*]_ _'s consent to serve is attached as Exhibit B. The beneficiary further requests that the Court appoint said Successor Trustee _ _[*with/without bond*]_ _.

Beneficiary believes that _ _[*name*]_ _'s appointment as Successor Trustee is in the best interests of the Trust and of those persons interested in the trust estate for the following reasons: _ _[*State reasons for appointment*]_ _.

[*Continue*]

5. The names and last known post office addresses of the beneficiaries of the Trust and all other persons who may be entitled to notice under Probate Code §17203, as far as known to Petitioner, are: _ _[*Insert names and addresses*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1*]

6. No one has filed a request for special notice in this proceeding.

[*Alternative 2*]

6. The following have filed request(s) for special notice in this proceeding: _ _[*Insert names*]_ _.

[*Continue*]

7. Beneficiary requests that the Court order _ _[*name*]_ _ to file an accounting with the Court detailing _ _[*his/her/its*]_ _ acts as Trustee, and direct that the accounting be filed no later than _ _[*e.g., 4 weeks*]_ _ after the Court makes its order.

8. Beneficiary believes that compensation in the amount of $_ _[*dollar amount*]_ _ is reasonable for _ _[*his/her/its*]_ _ attorneys' fees for this petition and that this amount should be charged as an expense of the trust and paid directly to the attorneys. Beneficiary also believes that this amount should be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income.

WHEREFORE, beneficiary requests that:

1. The Court remove _ _[*name of trustee*]_ _ as Trustee of the _ _[*name*]_ _ Trust and appoint _ _[*name of successor trustee*]_ _ as Successor Trustee to serve _ _[*with/without bond*]_ _. The Trustee shall deliver the Trust assets to the Successor Trustee within 30 days after issuance of the Order.

2. The Court order _ _[*name*]_ _ to file an accounting with the Court detailing _ _[*his/her/its*]_ _ acts as Trustee, no later than _ _[*e.g., 4 weeks*]_ _ after the Court makes its order.

3. The Court order beneficiary's attorneys' fees in the amount of $_ _[*dollar amount*]_ _ to be paid to such attorneys directly from the trust, to be charged _ _[*number*]_ _ percent to principal and _ _[*number*]_ _ percent to income, and paid within _ _[*e.g., 10 days*]_ _ after Court order.

4. The Court make all further and proper orders.

Date: _ _ _ _ _ _ __[*Signature*]__
Petitioner

[*Verification; see §7.116*]

Comment: It is important to make sure that the court both makes the order requested and sets deadlines for compliance. The failure of the trustee to comply with court-ordered deadlines strengthens the position of the cotrustee or beneficiary who seeks a removal.

Although there is no statutory authority for the court to order payment of a beneficiary's attorney fees from the trust, the petitioner may request such fees. See §4.31.

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§4.35 d. Response of Trustee

A trustee who believes that an attempted removal does not comply with the directions in the trust instrument should seek the advice of counsel. Failure to object could be considered a breach of fiduciary duty. See Nossaman & Wyatt, Trust Administration and Taxation §26.11[4]-[5] (rev 2d ed 1966). For discussion of payment of costs of defense, see §9.48.

In retaining the advice of counsel, the trustee must determine whether he or she is acting on behalf of the trust and in the interests of the trust's beneficiaries or in the trustee's personal capacity. If the trustee is acting in a fiduciary capacity, then the trustee must take into account the possibility that the trustee's confidential communications with an attorney may have to be disclosed to a successor trustee. See *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317. If the legal advice is being obtained in the trustee's personal capacity, *e.g.,* out of genuine concern for possible future charges of breach of fiduciary duty, the trustee should hire a separate lawyer and pay for the lawyer's advice out of the trustee's personal funds. *Moeller v Superior Court, supra*.

PRACTICE TIP: A trustee must be careful not to let an unrestricted right of removal by the beneficiaries influence his or her judgment and cause the trustee to acquiesce in their demands under the stated or implied threat of removal. To do so would be a breach of fiduciary duty as an unlawful delegation. See, *e.g., Martin v Bank of America* (1935) 4 CA2d 431, 41 P2d 200 (decision to invest may not be delegated). See generally §2.33. If only one beneficiary holds the power to remove, any favoring of this beneficiary over others would also be a breach of the duty of impartiality. See generally §2.56.

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§4.36 e. Hearing and Order

Pending the hearing, if the court finds that there would be a possible loss or injury to the assets of the trust or to the beneficiary of the trust, the court may order the trustee to surrender the trust assets to a temporary trustee designated by the court or to a cotrustee. Prob C §17206.

A beneficiary who objects to the removal of the trustee should file a petition in opposition, supported by declarations of the beneficiary stating reasons for opposing the removal. However, a beneficiary has no right to compel retention of a trustee who is unfit. See *Bowles v Superior Court* (1955) 44 C2d 574, 283 P2d 704.

The decision to remove is largely within the discretion of the court. *Estate of Gilmaker* (1962) 57 C2d 627, 633, 21 CR 585, 589; *Estate of Bixby* (1961) 55 C2d 819, 13 CR 411. If the trustee's capacity or ability to resist fraud or undue influence under Prob C §15642(b)(7)-(8) (see §4.25) is at issue, the court determines incapacity under the Due Process in Competence Determination Act (DPCDA) (Prob C §§810-813). The power should not be exercised lightly. The court's decision will depend not only on the facts and circumstances of the case (*Jones v Stubbs* (1955) 136 CA2d 490, 288 P2d 939), but on how the trustee who is to be removed assumed office. Courts will less readily remove a trustee named by a settlor or a testator than a trustee appointed by a third party or the court. See, *e.g., Estate of Bixby, supra*; *Jones v Stubbs, supra*; *Estate of Keyston* (1951) 102 CA2d 223, 227 P2d 17, disapproved on other grounds in *Estate of Schloss* (1961) 56 C2d 248, 256, 14 CR 643.

If the court finds that the petition for removal was filed in bad faith and that removal would be contrary to the settlor's intent, the court may order that the person or persons seeking the removal bear all or any part of the costs of the proceeding, including reasonable attorney fees. Prob C §15642(d).

If the court finds that the designation of a disqualified person under Prob C §15642(b)(6) was not consistent with the settlor's intent or was the product of fraud, menace, duress, or undue influence, the court must order that the person being removed as trustee bear all costs of the proceeding, including reasonable attorney fees. Prob C §15642(c).

If it appears to the court that trust property or the interests of a beneficiary may suffer loss or injury pending a decision and any appellate review, the court may, on its own motion or on petition of a cotrustee or beneficiary, compel the trustee whose removal is sought to surrender trust property to a cotrustee or to a receiver or temporary trustee, and the court may also suspend the trustee's powers to the extent the court deems necessary. Prob C §15642(e).

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§4.37 f. Form: Order Removing Trustee

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[*Caption; see §4.34*] **No. _ _ _ _ _ _**

ORDER REMOVING TRUSTEE, APPOINTING SUCCESSOR TRUSTEE, AND FOR PAYMENT OF ATTORNEYS' FEES

The petition of _ _[*name of beneficiary*]_ _ as beneficiary of the _ _[*name*]_ _ Trust, dated _ _[*date*]_ _, for Order To Remove Trustee and To Appoint Successor Trustee and for Payment of Attorneys' Fees was duly presented to this Court.

On proof made to the satisfaction of the Court, the Court finds that the allegations of the petition are true; that the attorneys for the beneficiary are entitled to compensation for services in the amount of $_ _[*dollar amount*]_ _ to be paid directly from the trust; that all notices of hearing have been given as required by law; and, good cause appearing, grants the petition as follows:

IT IS ORDERED that:

1. _ _[*Name*]_ _, Trustee of said _ _[*name*]_ _ Trust, is hereby removed.

2. _ _[*Name*]_ _ must render an accounting to the Court within _ _ _ days of the date of this Order.

3. _ _[*Name*]_ _ is hereby appointed as Successor Trustee of the _ _[*name*]_ _ Trust to serve _ _[*with bond in the amount of _ _[state amount*]_ _*/without bond*]_ _.

4. _ _[*Name*]_ _ is hereby ordered to turn over all assets and books and records of the _ _[*name*]_ _ Trust to the Successor Trustee no later than _ _[*date*]_ _.

5. _ _[*Names*]_ _, attorneys for the beneficiaries, are entitled to compensation in the amount of $_ _[*dollar amount*]_ _ to be paid from the trust, _ _ percent from principal and _ _ percent from income and paid within _ _[*e.g., 10 days*]_ _ after Court order.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

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§4.38 IV. POWER OF SURVIVING TRUSTEE ON RESIGNATION OR REMOVAL OF COTRUSTEE

If there are two or more acting trustees, on the death, resignation, or removal of any of them it is necessary to determine whether the remaining trustee or trustees can act alone or whether a successor cotrustee must be appointed. As in all other matters, the terms of the trust, if there are any, will control. Prob C §16000. If the trust is silent, the remaining trustee will have the legal power to act as sole trustee. Prob C §15621. In cases of temporary incapacity or absence, the remaining trustees can act to prevent irreparable injury or to accomplish the purposes of the trust. Prob C §15622. A trust agreement that names two or more original trustees should contain a provision stating what will happen on the death, resignation, or removal of any of them.

Unless a trust provides that a successor cotrustee must be appointed, there will be a vacancy only when there is no acting trustee. Prob C §15660. See *Estate of Tourny* (1957) 154 CA2d 501, 316 P2d 763; *Mutual Bldg. & Loan Ass'n v Wiborg* (1943) 59 CA2d 325, 139 P2d 73 (unless there was resignation or removal of trustee, no vacancy is created when named corporate trustee is merged into another corporate trustee and successor trustee assumes duties of prior trustee). On filling vacancies, see §§4.39-4.44.

Despite Prob C §15660, there are times when the beneficiaries want a successor to a cotrustee even when one is not required by the trust instrument. If such a situation occurs, the beneficiaries or a cotrustee may petition the court for instructions asking for the appointment of a successor cotrustee. Prob C §§15660(d), 17200(b)(10). The court apparently has discretion to appoint a trustee in order to maintain not more than the original number of trustees provided in the trust instrument. Prob C §15660(d). The attorney for the remaining trustee should discuss with him or her whether to object to a beneficiaries' petition. Factors to consider are the experience of the existing and potential trustees, the nature of the assets, the size and location of the trust estate, and the amount of compensation available for the trustees.

PRACTICE TIP: Often, a court will approve compensation based on the value of the assets and then order it divided equally among the trustees. The trustees can have a different agreement; for example, an individual trustee may be willing to waive compensation so that the corporate trustee (who often does most of the work) can receive the entire trustee's fee and be willing to continue to act as trustee.

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§4.39 V. FILLING VACANCIES

Under Prob C §15643, the office of trustee is vacant when any of the following occurs:

- The person named as trustee rejects the trust.
- The person named as trustee cannot be identified or does not exist.
- The trustee resigns or is removed.
- The trustee dies.
- A conservator or guardian of the person or estate of an individual trustee is appointed.
- The trustee files a petition for adjudication of bankruptcy or for approval of an arrangement, composition, or other extension under the federal Bankruptcy Code, or a petition filed against the trustee for any of these purposes is approved.
- A trust company's charter is revoked or powers are suspended, if the revocation or suspension is to be in effect for a period of 30 days or more.
- A receiver is appointed for a trust company if the appointment is not vacated within a period of 30 days.

The trust does not fail when the office of trustee falls vacant (see §4.40), but the vacancy must be filled as provided in Prob C §15660, whether by the terms of the trust (see §4.41), by agreement of the beneficiaries and a trust company (see §4.42), or by court appointment (see §4.43). In some cases, a bond may be required. See §4.44.

Care must be taken in the selection of an individual trustee to fill the vacancy. The selection of a non-U.S. person as trustee will make a U.S. trust a foreign trust. IRC §7701(a)(30)(E), (a)(31)(B). Failure to meet the reporting requirements for foreign trusts (*e.g.*, IRS Forms 3520 and 3520A) may subject the trust to penalties of up to 35 percent on trust assets. IRC §6677(a). For a detailed discussion of foreign trusts, see Drafting California Irrevocable Trusts §§3.68-3.75 (3d ed Cal CEB 1997).

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§4.40 A. Trust Does Not Fail Due to Lack of Trustee

A trust does not terminate when there is no trustee acting. Prob C §15660(a) ("the vacancy shall be filled as provided in this section"). See also *Estate of Barter* (1947) 30 C2d 549, 184 P2d 305. Instead, if a trustee has rejected the trust, resigned, been removed, or died, a new trustee must be appointed. If the trust instrument names a successor, that person, if he or she accepts, will become trustee; if the trust instrument provides a method of appointing a trustee, the vacancy must be filled as provided in the trust instrument. Prob C §15660(b). See §4.41. A court order will clearly indicate the date on which the successor assumed responsibility for the trust assets. Because this protection does not exist in nonsupervised trusts, the new trustee should indicate acceptance in writing, as of a specified date, so that it is clear when he or she assumed responsibility. Some practitioners recommend a notary acknowledgment as a useful method for confirming the date of acceptance by a trustee.

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§4.41 B. Vacancy Filled by Terms of Trust

The terms of the trust instrument, if there are any, will control the appointment of a successor. Prob C §15660(b). Trusts may name one or more successor trustees or may provide that the successor will be chosen by a majority of the adult, competent income beneficiaries of the trust. If, under a provision like the latter, the beneficiaries fail to agree on a successor, a beneficiary or any trustee then in office will have to petition the court for instructions. See §15.26. Other trusts give the power to appoint a successor to the trustee then in office (see Drafting California Revocable Trusts §16.55 (4th ed Cal CEB 2003)) although corporate trustees will often refuse to exercise this power for fear they will assume liability for any actions of the successor. Some trusts provide that the court is to appoint a successor. See §4.43.

PRACTICE TIP: Resources for successor trustees include the Professional Fiduciary Association of California, headquartered in Sacramento, which will provide a list of its members who act as trustees.

The trust may have restrictions on who can be appointed as successor trustee, such as limiting appointment to corporations with a certain amount of capital. Any restrictions must be followed unless modified by the court. If the trust is silent, the trustee also may be appointed by agreement without court approval. See §4.42.

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons) and that will have total assets of more than $20,000 after receipt of those funds—the trust instruments must require court approval of changes in trustees and a court order appointing any successor trustee. Cal Rules of Ct 7.903(a)(1), (c)(7), (d).

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Source: Estate Planning/California Trust Administration/4 Rejection of Trust; Resignation and Removal of Trustee/§4.42 C. Vacancy Filled by Agreement of Beneficiaries and Trust Company

§4.42 C. Vacancy Filled by Agreement of Beneficiaries and Trust Company

As an alternative to court appointment, when the terms of the trust do not specify a successor trustee or how one will be chosen, a trust company that agrees to accept the trust may be appointed by agreement among the beneficiaries. Probate Code §15660(c) permits a vacancy in the office of trustee to be filled, without the need for court approval, by a trust company selected by agreement of the adult beneficiaries who are receiving or are entitled to receive income under the trust or to receive a distribution of principal if the trust is to be terminated at the time the agreement is made. If a beneficiary has a conservator, the conservator may agree to the successor trustee on the conservatee's behalf without obtaining court approval. If the beneficiary has appointed an attorney-in-fact who has the power under the power of attorney to agree to the successor trustee, the attorney-in-fact may agree to the successor trustee.

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Source: Estate Planning/California Trust Administration/4 Rejection of Trust; Resignation and Removal of Trustee/§4.43 D. Vacancy Filled by Court

§4.43 D. Vacancy Filled by Court

If the trust instrument is silent about choosing a successor trustee and the vacancy is not filled by agreement of the adult beneficiaries and a trust company, an interested person or a person named as trustee in the trust instrument will have to petition the court to appoint one. Prob C §15660(d); *Bowles v Superior Court* (1955) 44 C2d 574, 283 P2d 704. The beneficiaries of a trust may nominate a successor. See Prob C §15660(d), which provides that the court shall give consideration to any nomination by beneficiaries who are 14 years of age or older. If the trust provides for more than one trustee, the court may, in its discretion, appoint the original number or any lesser number of trustees. Prob C §15660(d). In *Arman v Bank of America* (1999) 74 CA4th 697, 88 CR2d 410, the court held that the daughter of a deceased person who had been nominated to be successor trustee of a charitable remainder trust on the death of the last noncharitable beneficiary did not have standing to seek appointment of herself as successor trustee.

PRACTICE TIP: Because the court will not generally permit the appointment of successive trustees, but will deal with the issue one vacancy at a time (except when cotrustees are appointed and one may continue to act alone if the other ceases to act), it is recommended that careful thought be given to the age of the proposed successor and the anticipated duration of the trust. If it is not anticipated that the trustee will be available for the entire duration of the trust, multiple court petitions will be necessary.

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§4.44 E. Bond for Trustee

A bond may be required for the trustee who fills the vacancy:

- If the trust instrument so provides (Prob C §15602(a)(1)) (except in the case of a trust company; Prob C §15602(e));
- Even if there is a waiver of bond in the trust instrument, if the court finds it necessary to protect the interests of beneficiaries or other persons having an interest in the trust (Prob C §15602(a)(2)); or
- If an individual not named as a trustee in the trust instrument is appointed as a trustee by the court (Prob C §15602(a)(3)). See discussion of successor trustees in §4.49.

Even if the trust instrument does require a bond and a person who is not named as a trustee in the trust instrument is appointed as a trustee by the court, if all the adult beneficiaries agree to waive bond, this constitutes "compelling circumstances" requiring the court to waive bond. Prob C §15602(b). This section seems to require the court to waive bond regardless of possible or probable harm to a minor beneficiary of the trust.

NOTE: Probate Code §15602(b) does not define "adult beneficiaries." Does the phrase "all the adult beneficiaries" include only adult income beneficiaries, or adult income and remainder beneficiaries? Is it possible that a court may decline to find that "all" the adult beneficiaries have been noticed when the catch-all beneficiary designation of "then-living heirs" of the settlor may include many potential adult beneficiaries? A similar conundrum arises in the context of giving notice to beneficiaries. See §4.13.

If a nonprofit charitable corporation is appointed trustee, the court may not waive bond, but may reduce it in its discretion. Prob C §15604(g)(1). See §2.78 on nonprofit charitable corporations.

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VI. DUTIES OF TRUSTEE ON RESIGNATION OR REMOVAL

§4.45 A. Completion of Resignation or Removal

A trustee remains a trustee, with all the attendant duties, until he or she has resigned or has been removed. A resignation is effective only as provided in Prob C §15640 and removals are governed by Prob C §15642. In both situations there are normally opportunities to ensure an orderly transition of duties. Assets must still be managed and accounts kept, and the trust assets and records must be gathered for the successor (see *Bixby v Hotchkis* (1943) 58 CA2d 445, 452, 136 P2d 597, 601), tasks that can be characterized as normal trustee obligations. Once the resignation or removal is complete, Prob C §15644 gives the departing trustee the powers necessary to preserve the trust estate and to complete administration.

PRACTICE TIP: When drafting trust agreements, consider including a provision that a trustee who becomes incapacitated will be deemed to have resigned as trustee.

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§4.46 B. Management of Assets

The resigning or removed trustee must turn over the trust assets to a successor trustee within a reasonable period of time. Prob C §15644; see Restatement (Second) of Trusts §344 (1959). What is reasonable will depend on the individual circumstances, such as the types of assets, whether a successor is immediately available to take over, or whether there is litigation or pending negotiations concerning investments. See, *e.g., Bixby v Hotchkis* (1943) 58 CA2d 445, 136 P2d 597.

Until all the assets are turned over to a successor, the resigning or removed trustee remains responsible for the trust property and has the powers "reasonably necessary under the circumstances" to preserve the trust property until it is delivered and to perform actions necessary to complete the resigning or removed trustee's administration. Prob C §15644. This appears to be a more restrictive formulation than that of Restatement (Second) §344 and *Bixby v Hotchkis, supra,* which require the trustee to manage the trust until the assets are delivered.

If any important actions must be taken, the outgoing trustee should consult with the successor. If none is available, the outgoing trustee should discuss with the beneficiaries their preference and petition the court for instructions. See §15.26. If the trustee has attempted to resign by obtaining the consent of the beneficiaries (Prob C §15640(c) or holder of the power to revoke (§15640(b)) but has not been able to obtain the proper consent, or by following the provisions of the trust instrument (§15640(a)) but for some reason the attempt has failed, the trustee should petition the court under Prob C §§15640(d) and 17200(b)(11). Until the court issues an order accepting the resignation, the resigning trustee remains the trustee, with all the powers and duties.

If the outgoing trustee fails to transfer the assets within a reasonable time, the successor trustee should either do the actual transfers of title and take possession of the assets, or petition the court for instructions, asking the court to order the trustee to transfer title and turn over the assets or to order the financial institutions where trust assets are held to turn the assets over to a new trustee. The court can also make an order transferring the trust real property to the new trustee. An order affecting real property should contain a legal description of the real property and, to effect the transfer, certified copies must be recorded in each county where the trust real property is located. Alternatively, the trustee can execute and record an affidavit of change of trustee affecting real property. See §4.57.

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§4.47 C. Preparation of Accounting

The trustee must gather the books and records of the trust to turn them over to the successor. The "books and records" include all correspondence, including communications between the trustee and the attorneys for the trustee acting as a fiduciary, tax returns, accounting information of receipts and disbursements, insurance policies, information regarding trust beneficiaries, and valuations of trust property. See *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317. The successor should receive the original governing instrument, with all amendments, and copies (if originals are not available) of all other important documents. See chap 7. The trustee should also arrange for registration of the trust assets in the name of the new trustee. The trustee should prepare an accounting to the beneficiaries. Prob C §16062(a). Even if it is not required by court order, the resigning trustee should also prepare an accounting for the successor trustee. If the trustee is incompetent, the trustee's conservator should prepare any formal accounting required. If the trustee is deceased, this responsibility lies with the trustee's personal representative, although the attorney for the trustee may be able to assist in its preparation. If there is no personal representative, the trustee's attorney may request a court order, authorizing the attorney to prepare, or have prepared by a competent professional, an accounting complying with Prob C §§16060-16064. This account will be unverified.

NOTE: If there are cotrustees and one resigns, the remaining cotrustee must prepare the accounting.

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VII. SUCCESSOR TRUSTEE

§4.48 A. Decision to Accept Appointment

Someone—usually the prior trustee or the attorney for the trustee—must notify the successor trustee of his or her nomination as trustee. Then the nominee must decide whether to accept or decline the appointment. A nominee who does not wish to serve should reject the appointment rather than accepting and then resigning. See §4.1. An acceptance should be in writing. For form used for Consent to Act as Successor Trustee, see §4.16.

The nominee must consider many factors in deciding whether to accept appointment as trustee, such as the amount of time it will take to manage the trust, the nature of the trust assets, and relationships with the beneficiaries. In addition, the successor should consider the prior administration of the trust, the condition of the books and records, and the reason for the prior trustee's resignation or removal. See §4.52. If the trust's records are in disarray, consider the appointment of a corporate trustee or independent professional to take over the trust. Consider obtaining a court order insulating the successor trustee from liability for problems created by the prior trustee. A nominee who is a beneficiary should also consider, with the advice of counsel, whether accepting the appointment would have any adverse tax consequence for the trust or the successor trustee. See California Will Drafting §28.8 (3d ed Cal CEB 1992).

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§4.49 B. Bond for Successor Trustee

Probate Code §15602(a)(3) provides that successor individual trustees not named in the trust instrument are required to be bonded, but the trust instrument may override this requirement by specific reference to successor trustees. Further, if all adult beneficiaries request that bond be waived for a successor trustee not named in the trust instrument, the court may not impose bond. See Prob C §15602(b). See discussion in §4.44.

Even if a bond is required by the trust instrument, the court may excuse the requirement of a bond, reduce or increase the amount of a bond, release a surety, or permit the substitution of another bond with the same or different sureties. Prob C §15602(b).

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C. Duties of Successor Trustee

§4.50 1. Review Trust Instrument and Notify Beneficiaries

Before accepting appointment and again immediately after appointment, the successor trustee should review the trust instrument to determine his or her duties and powers as trustee. The successor should in any event talk with the beneficiaries to determine their needs. Although the prior trustee has presumably done this at routine intervals, it is important that the successor establish a rapport with the beneficiaries and make sure that circumstances have not changed and that their needs are being met. However, the trustee must make an independent assessment of the beneficiaries' needs as well as considering the needs of the contingent remainder interests. See §§2.58-2.59. Before accepting appointment, the trustee may wish to obtain a court order, under Prob C §17200, clarifying ambiguous provisions of the trust agreement or instructing the trustee regarding controversial actions and discretionary expenditures.

Probate Code §16061.7(a)(2) and (f) provides that the successor trustee must notify the beneficiaries of the trustee change within 60 days after the successor trustee begins to serve as trustee.

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§4.51 2. Take Charge of Assets

The primary duty of a successor trustee is to take charge of the assets when his or her appointment becomes effective so that there will be continuous administration of the trust. A trust may provide that the predecessor trustee's resignation is not effective for a certain period of time. Nonetheless, the successor should make sure that the predecessor trustee is taking prompt action to turn over the assets so that the successor will be able to take over when the waiting period has expired. If the prior trustee is deceased, the successor trustee should confer with the attorney for assistance in gathering the trust's books and records.

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§4.52 3. Investigate Prior Trustee's Acts

Under common law, the successor trustee has a duty to investigate the acts of the prior trustee. Nossaman & Wyatt, Trust Administration and Taxation §27.03[2] (rev 2d ed 1966). Under Prob C §16403(b), the successor trustee may be liable to the beneficiaries if:

- The successor knows or has information from which he or she reasonably should have known of a situation constituting a breach and improperly permits it to continue;
- The successor neglects to take reasonable steps to compel the predecessor to deliver the trust property to the successor trustee; or
- The successor neglects to take reasonable steps to redress a breach of trust committed by the predecessor trustee in a case where the successor knows or reasonably should have known of the predecessor's breach.

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§4.53 a. Protect Against Liability

Some investigation by the successor trustee would seem to be called for to avoid liability. The successor trustee may be relieved of this duty, in whole or in part, by the instrument. See California Will Drafting §§28.49-28.50 (3d ed Cal CEB 1992). Probate Code §§16463-16465 address limited circumstances in which a trust beneficiary may be asked to release the trustee. Generally, however, a trustee—especially a successor trustee—as a fiduciary, should never rely on a beneficiary's release. Instead, a successor trustee should seek court ratification or instructions under Prob C §17200. This will be given only after all beneficiaries have notice and an opportunity to agree or object. Such a court order offers the successor trustee greater protection from beneficiaries who are incapacitated, minors, or remainder beneficiaries at the time the trustee seeks to resign.

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§4.54 b. Review All Records and Documents

The trustee should review prior fiduciary tax returns and court accountings. There may be language in the instrument that provides that the successor trustee can accept as correct an accounting by the predecessor. See California Will Drafting §28.50 (3d ed Cal CEB 1992). Even if this language is in the instrument, if the successor has actual knowledge that assets belonging to the trust have not been delivered, the successor has a fiduciary responsibility to collect these assets.

The successor trustee should review the accountings and books and records of the trust. This review should include any accountings, statements to beneficiaries, books and records kept by the prior trustee, and tax returns. The trust instrument may relieve the successor of this responsibility. See Will Drafting §28.50. If there is no such language, the successor trustee will be liable for the consequences of the prior trustee's mismanagement of which the successor knew or should have known. Prob C §16403(b). A beneficiary will have the choice of suing either the prior or the successor trustee, or both, for the prior trustee's mismanagement. See chap 15. Even if the trust instrument relieves the successor trustee of the obligation to review, the successor will be liable if he or she knows of the mismanagement and fails to take action. See 4 Scott & Ascher on Trusts §24.28.1 (5th ed 2007); Restatement (Second) of Trusts §223, Comment b (1959).

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§4.55 4. Take Action Against Prior Trustee

To minimize potential liability, the successor trustee may consider requiring the prior trustee, if living, to account to the court. Alternatively, a named successor can request an audit of the trust records before accepting appointment. See *Boyle v Superior Court* (1934) 137 CA 672, 31 P2d 828.

Because the successor trustee has a responsibility to redress the prior trustee's breach, the successor should demand repayment by the prior trustee for damages caused by the trustee's mismanagement. If the prior trustee refuses to pay, the successor should institute a lawsuit against the prior trustee. The successor and his or her attorney should consider petitioning the court for instructions for authority to expend trust funds before taking any action.

If the prior trustee is deceased, the successor should consider filing a protective claim in the deceased trustee's estate on behalf of the trust if there is concern about possible surchargeable error. A protective claim is a creditor's claim filed to "protect" the trust's interests. See Prob C §9000(c). As a potential creditor, the successor trustee must act promptly. See Prob C §9100. As a result, the claim may have to be filed before the trust records can be obtained and thoroughly reviewed. If, after review, the prior trustee's records are found to be in order, the successor trustee can then withdraw the protective claim. Because the original claim might, of necessity, have been vague as to the amount of the claim, an amended claim should be filed as soon as specific information is available.

On the issue of attorney-client privilege when a successor trustee seeks to discover the advice of a predecessor trustee's counsel, see *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317. See also *Eddy v Fields* (2004) 121 CA4th 1543, 18 CR3d 487.

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§4.56 D. Powers of Successor Trustee

Unless the trust instrument provides otherwise, the successor or surviving trustee will have all the powers that were given to the original trustee. See Restatement (Third) of Trusts §85 (2007). See also Restatement (Second) of Trusts §196 (1959). The powers of the trustee vest in the office, not in a particular individual named as trustee. See *Borissoff v Taylor & Faust* (2004) 33 C4th 523, 15 CR3d 735 (successor trustee has same powers as predecessor trustee, including power to sue attorney hired by predecessor for malpractice); *Eddy v Fields* (2004) 121 CA4th 1543, 18 CR3d 487; *Estate of Canfield* (1947) 80 CA2d 443, 181 P2d 732. This is true even if the instrument does not specifically provide that the successor has all powers granted to the original trustee. It is still best to have language in the instrument to avoid any difficulty. For sample language, see California Will Drafting §28.12 (3d ed Cal CEB 1992).

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VIII. AFFIDAVIT OF CHANGE OF TRUSTEE

§4.57 A. Content and Effect of Affidavit

If title to an interest in real property is affected by a change of trustee, the successor may, but is not required to, execute an affidavit of change of trustee and record it in the county where the property is located. The affidavit must include the legal description of the property and the names of the former and successor trustee or trustees. Prob C §18105.

The affidavit may include excerpts from the original trust document, any amendments to the trust, and any other documents evidencing or pertaining to the succession of successor trustees. Prob C §18105. Any person whose interest is, or may be, affected by the recordation of the affidavit may require the successor to supply copies of those excerpts, amendments, or documents. Prob C §18108. For sample form, generally similar to a certification of trust (see §2.65), see §4.59.

The affidavit must meet all statutory requirements for recorded documents, and the recorder must index it in the index of grantors and grantees. Prob C §18106. Once properly recorded, it is prima facie evidence of the change of trustee insofar as it identifies an interest in real property in the county, title to which is affected by the change of trustee. This presumption affects the burden of producing evidence. Prob C §18107.

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Source: Estate Planning/California Trust Administration/4 Rejection of Trust; Resignation and Removal of Trustee/§4.58 B. Practical Considerations

§4.58 B. Practical Considerations

The affidavit may be used when a trustee resigns, dies, or is removed. Because a primary purpose is to inform third parties (*e.g.,* title companies) of who is in charge of real property, it is good practice, though not required, to record the affidavit in each county where real property is owned promptly after a change in trustee has occurred. Further, although not required by the statute, it is important for third parties to know why the trustee has been replaced.

If the trustee resigns, a signed and acknowledged resignation can follow the affidavit as an attachment. Alternatively, the document may include the affidavit and resignation, and can be entitled "Resignation of Trustee and Succession of and Acceptance by [name of successor] as Successor Trustee." In either case, the document should refer to the resignation attached to the instrument.

If the trustee has died, a certified death certificate should be attached and referred to. If the trustee has been removed, a certified court order should be attached and referred to. If the trustee has become incapacitated, and incapacity is to be determined by a doctor or other person or persons, an acknowledged certification or certifications should be attached.

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§4.59 C. Form: Affidavit of Change of Trustee

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

AFFIDAVIT OF CHANGE OF TRUSTEE

_ _[*I/We*]_ _, the undersigned, hereby certify and declare:

1. The name of the Trust to which this affidavit applies is _ _[*name*]_ _.

2. The Trust was created on _ _[*date*]_ _ by _ _[*name(s)*]_ _ as settlor(s).

3. The former Trustee(s) _ _[*is/are*]_ _ _ _[*name(s)*]_ _.

4. The currently acting Trustee(s) _ _[*is/are*]_ _ _ _[*name(s)*]_ _, having succeeded the former Trustee(s) on _ _[*date*]_ _ by reason of _ _[*Explain right of succession (e.g., resignation/death/removal/incapacity) of former trustee and include excerpts from trust instrument or amendments, if desired*]_ _. See the attached _ _[*e.g., signed and acknowledged resignation/certified death certificate/court order/certification*]_ _.

5. The Trust holds the following interest(s) in real property: _ _[*legal description of interest(s), assessor's parcel number(s), street address(es)*]_ _.

6. This affidavit is being signed below by all of the currently acting Trustees of the Trust.

Date: _ _ _ _ _ _ __[*Signature(s)*]__
_ _[*Typed name(s)*]_ _

State of California)
County of _ _[*name of county*]_ _)
_____)

Subscribed and sworn to (or affirmed) before me on this _ _[*number*]_ _ day of _ _[*month*]_ _, 20_ _, by _ _[*name(s) of trustee(s)*]_ _, proved to me on the basis of satisfactory evidence to be the person(s) who appeared before me.

__[*Signature of officer*]__ [*Officer's seal*]

Comment: The jurat language is prescribed by Govt C §8202. The sample form may be revised, within the parameters of Prob C §18105, to fit the particular situation. Be sure to add attachments as appropriate (*e.g.,* signed and acknowledged resignation, certified death certificate, court order, or certification of trust).

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5

Investments and Management of Assets

Bart J. Schenone

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§5.1 I. GOVERNING PRINCIPLES OF INVESTMENT

A trustee has the duty to invest trust property for the benefit of the beneficiaries, subject, however, to any restrictions or limitations stated in the trust instrument. See §5.7. In carrying out this duty, the trustee is subject to the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054), unless the trust instrument provides a greater or lesser standard of care. See §§5.24-5.25.

The trustee's investment powers usually are derived from the trust instrument. Prob C §16200(a). If not, these powers are set by statute (Prob C §§16200(b), 16047), case law, and by the circumstances of the trust and its beneficiaries. All of these sources of investment powers are considered in determining whether an investment is proper. See *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644. For discussion of a trustee's management and investment duties and powers, see §§5.6-5.19.

Although trustees are to be guided by modern investment theory, they must keep in mind the underlying purpose of making investment decisions, which is to carry out the purposes of the trust for the benefit of the beneficiaries. Therefore, trustees must also consider the requirements of administering the trust with regard to trust taxation, recordkeeping, and trust accounting under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375).

For national bank trustees, see 12 CFR §9.11. Probate Code §16042 sets out the standard of care with respect to trust property held by the public guardian or administrator appointed as trustee of a trust under Prob C §15660.5. See §5.40. The trustee's investment and management decisions will also be held to the standards of the general trustee's duties. Prob C §§16000-16105. See chap 2. In addition, many corporate trustees are subject to Comptroller of the Currency regulations regarding investments. See 12 CFR §§9.1-9.20. For discussion of standard of care, see §§5.2-5.5.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.2 A. Investment Standard of Care

§5.2 A. Investment Standard of Care

The following statutes establish the standard of care to which the trustee will be held in making management and investment decisions:

- Probate Code §§16045-16054 (Uniform Prudent Investor Act (UPIA)), which govern investment and management of trust assets, and more specifically Prob C §16047, which provides the standard of care for investment decisions made on or after January 1, 1996;
- Probate Code §16014, which sets out a general duty to use skill; and
- Former Probate Code §16040(b), which provides the standard of care for actions and decisions made by a trustee before January 1, 1996, for trusts in existence before that date. Prob C §16054.

NOTE: Probate Code §16040 sets out the prudent person rule that applies to trust administration, except for investment and management decisions, which are governed by the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054).

NOTE: A trustee's standard of care and performance is not affected by whether the trustee receives any compensation. Prob C §16041.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.3 1. Prudent Investor Rule of UPIA

§5.3 1. Prudent Investor Rule of UPIA

In exercising its investment powers, the trustee must comply with the requirements set forth in the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) unless the instrument otherwise provides. Prob C §16046(b). Probate Code §16047(a) and (b) provide the standard of care a trustee must use in investing under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054):

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

The UPIA specifically recognizes the importance of analyzing both risk and return consistent with modern investment theory.

NOTE: Probate Code §16042 sets out the standard of care for trust property held by the public guardian or administrator appointed as trustee of a trust under Prob C §15660.5. See §5.40.

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§5.4 2. General Duty to Use Skills

Although it is anticipated that an individual of ordinary intelligence and without special skills may serve as trustee, trustees have a duty to apply the full extent of their skills. Prob C §16014. Further, a professional trustee is typically held to a higher standard of care than the average individual. *Estate of Beach* (1975) 15 C3d 623, 125 CR 570; *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644.

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§5.5 3. Prudent Person Rule

The prudent person rule of former Prob C §16040(b) continues to apply to all actions and decisions (including investment management) made by a trustee before January 1, 1996. This section provided that the trustee must

> act with the care, skill, prudence, and diligence under the circumstances then prevailing, including but not limited to the general economic conditions and the anticipated needs of the trust and its beneficiaries, that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument. In the course of administering the trust pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.

This standard applied, before January 1, 1996, not only to initial investment decisions, but to all aspects of the trustee's management of the trust property, including reinvestments, purchases, sales, and exchanges.

NOTE: The "prudent person rule" found in Prob C §16040(a) governs trust administration generally. This section, however, is explicitly made inapplicable to investment and management functions under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054). Prob C §16040(c). See §5.3. For discussion of Prob C §16040(a), see chap 2.

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B. Trustee's Duties

§5.6 1. Duty to Review Assets and Develop Investment Strategy

Under Prob C §16049, the trustee must, within a reasonable time of accepting the trusteeship or receiving the assets, review the assets and make and implement decisions concerning the retention and disposition of assets so as to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust. See §§5.22-5.23.

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§5.7 2. Duty to Invest and Make Property Productive

The trustee ordinarily has a duty to invest trust property, preserve it, and make it productive. Prob C §§16006-16007. The duty to invest extends to accumulated but undistributed income as well as principal. *Lynch v John M. Redfield Found.* (1970) 9 CA3d 293, 88 CR 86. The duty to invest, however, is not absolute. The settlor may negate this duty to invest through express language in the trust instrument. Prob C §§16000, 16046(b). A trustee is under no duty to invest if abstaining from investment is consistent with the purposes of the trust and reasonable under the circumstances. See *Higgins v City of Santa Monica* (1964) 62 C2d 24, 41 CR 9, in which the court held that a trustee of public land was under no duty to invest because the trust was intended to preserve property for public enjoyment, not to generate income. *Higgins,* however, dealt with an unusual situation; a court normally would not approve a trustee's complete failure to invest. See *Conservatorship of Pelton* (1982) 132 CA3d 496, 183 CR 188, in which the court held that a corporate conservator should invest funds awaiting distribution at a higher rate than that available from its own savings accounts.

A trustee is not obligated to invest assets that are needed to pay trust expenses within a short time. See *Lynch v John M. Redfield Found., supra*. The trustee has the latitude to take a reasonable period of time researching investment opportunities. The circumstances of the trust determine reasonableness. If there is an unreasonable delay, the trustee may be liable for losses due to the breach of trust. See *Lynch v John M. Redfield Found., supra*.

National bank trustees must comply with the requirements of 12 CFR pt 9. Under 12 CFR §9.10, fiduciary accounts must not remain uninvested any longer than is "reasonable for the proper management of the account and consistent with applicable law." The bank should obtain a rate of return that is consistent with applicable law. 12 CFR §9.10(a).

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§5.8 3. Duty to Diversify

Probate Code §16048, a provision of the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054), requires that, "in making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." Case law also places a duty on trustees to diversify investments. See *Estate of Beach* (1975) 15 C3d 623, 634 n9, 125 CR 570; *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644. Unless the trust instrument provides otherwise or it is imprudent to do so, the trustee must distribute the risk of loss by reasonably diversifying the portfolio, *i.e.,* the trustee must invest trust funds in more than one asset and type of assets. For practical considerations regarding the duty to diversify, see §§5.29-5.32.

For discussion of situations that empower or require the trustee to retain trust assets, see §§5.27 and 5.28, respectively.

NOTE: The requirements of the UPIA can be expanded, restricted, eliminated, or altered by the provisions of the trust, and the trustee is not liable to a beneficiary to the extent the trustee acts in reasonable reliance on the trust provisions. Prob C §16046(b).

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§5.9 4. Duty to Consider Beneficiaries' Needs

As part of the duty to deal impartially with beneficiaries, a trustee must consider the interests and needs of all beneficiaries in making investment decisions within the terms of the trust instrument. Prob C §16003. *Estate of Bissinger* (1963) 212 CA2d 831, 28 CR 217. See §5.3 for factors to consider under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054).

The trustee of an irrevocable trust must consider the interests of both the income and remainder beneficiaries. Even when a beneficiary holds a general power of appointment, the interests of contingent beneficiaries must be considered because the beneficiary might fail to exercise the power. Beneficiaries may have competing interests, *e.g.,* an income beneficiary may need as much income as possible if the trust is the beneficiary's sole source of support, but the remainder beneficiaries are entitled to some capital growth.

Thus, not all assets need be income producing if the interests of remainder beneficiaries are best served by holding property for its appreciation in value. In addition, the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) may allow the trustee to allocate a portion of the appreciation of the investments to the income (or current) beneficiary (Prob C §16336) or convert the income interest to a unitrust interest (Prob C §16336.4). See chap 8.

The trustee cannot unreasonably and imprudently endanger the safety of principal or hold property subject to depletion or depreciation in order to produce greater income. The trustee may hold unproductive or underproductive property to increase capital appreciation if doing so is a part of an overall investment strategy.

When two or more income beneficiaries have disparate personal income tax brackets, the trustee must normally, absent other indications of the settlor's intent, strike a balance between them in determining how much to invest in assets producing tax-free income.

When the governing instrument directs the trustee to prefer one class of beneficiaries over another, the trustee must follow these directions. Prob C §16000. The trustee's attorney should review any clauses expressing preferences between classes of beneficiaries.

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§5.10 5. Duty to Keep Beneficiaries Informed

Probate Code §16060 requires the trustee to keep the beneficiaries "reasonably informed of the trust and its administration." Probate Code §16062 requires the trustee to account to the current beneficiaries at least annually, at the termination of the trust, and on a change of trustee. Probate Code §16061 provides that, on reasonable request by a beneficiary, the trustee must provide the beneficiary with a report of information regarding the assets, liabilities, receipts, and disbursements of the trust, the acts of the trustee, and the "particulars … relevant to the beneficiary's interest, including the terms of the trust." In *Esslinger v Cummins* (2006) 144 CA4th 517, 50 CR3d 538, the court held that a remainder beneficiary had standing to petition for an order compelling the trustee to provide annual accounts for prior years. The court noted that a remainder beneficiary not entitled to an account under Prob C §16062 may be entitled to a "particular account" under Prob C §16061. See Comment to Prob C §16061. For discussion of the requirements governing trustees' accounts to beneficiaries, including waivers, see chap 7. Informing beneficiaries about the trustee's investment decisions is a necessary ingredient of the report of information required by Prob C §16060.

Apart from the statutory requirements to keep the beneficiaries informed, however, a trustee may find it both prudent and sensible to maintain regular communications with the trust beneficiaries, in particular when extraordinary transactions are involved, such as in the sale of real property or of a concentrated asset. *Estate of Talbot* (1956) 141 CA2d 309, 296 P2d 848.

NOTE: In communicating with the trust beneficiaries, however, the trustee should take care not to improperly delegate authority regarding investment decisions to those beneficiaries when the right to direct the trustee or veto investment decisions is not explicit in the trust document.

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6. Duty to Avoid Self-Dealing, Impropriety, and Conflicts of Interest

§5.11 a. Buying or Selling Assets

It is not improper per se for the trustee to buy from or sell to a trust beneficiary. See Prob C §16004; 3 Scott & Ascher on Trusts §18.1.4.4 (5th ed 2007). A charge of impropriety can arise if there is a dispute over the proper value of the asset. If the asset is a publicly traded security, its fair market value is easily established by newspapers or published reports; but if the asset is not traded publicly and a fair market value cannot be readily established, the trustee should employ a professional, disinterested appraiser to set the market value. In any purchase or sale with a trust beneficiary, the trustee must avoid actions that could be construed as showing preference for one beneficiary at the expense of the trust or another beneficiary. See Prob C §§16003-16004.

NOTE: A sale of a stock of a well-established, well-managed company with a great growth potential, even at a publicly traded price, could be viewed as favoring one group of beneficiaries if, *e.g.,* sound investment advice would dictate holding the stock for long-term growth.

It would be unusual for a trustee to consider purchasing an asset from a beneficiary, unless the property were jointly owned and the trustee concluded that the interests of the trust would be better served by owning 100 percent of the asset in question. Far more typically, a beneficiary may wish to purchase an asset of the trust that has sentimental or economic value, such as a business interest, artwork, or jewelry.

PRACTICE TIP: When the asset in question has considerable value, the trustee should send a written notice of the proposed purchase or sale to all the adult beneficiaries and consider seeking court confirmation under Prob C §17200 in order to avoid potential criticism of the proposed transaction.

Frequently, the purchase or sale of trust property by a trustee or beneficiary is a "red flag" of impropriety that overshadows the underlying consensus. When conflicting appraisals arise because assets are difficult to value, the impropriety can become dangerous to the fiduciary's continued tenure. It is prudent, therefore, for a trustee to adopt a policy of declining to self-deal, even when the underlying circumstances indicate that a transaction is appropriate. Caution should guide a fiduciary's action.

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§5.12 b. Assets Owned by Trust and Beneficiary

The trustee may be asked to participate on the trust's behalf in an investment, *e.g.,* a limited partnership, in which the beneficiary is also a participant. If the interests are separate and the trustee makes an independent judgment that the investment is proper for the trust, there is no legal bar to the investment. See Prob C §§16002, 16012. It is good practice to disclose the investment and the beneficiary's interest to all other interested parties. If the trust is subject to continuing court supervision, the court too should be advised. If the trust is not subject to continuing court supervision, the trustee may petition the court under Prob C §17200 for instructions. Disclosure deflects charges of improper delegation of duty or other breaches if the investment proves ill-advised.

Commercial or other income-producing real property requires active management by the trustee. The fact that the trust and a beneficiary share ownership of an asset does not give the trustee a right to delegate ultimate decision-making authority over the asset either to the beneficiary or to an outside property manager. Prob C §16012. In such situations, the trustee and beneficiary should negotiate an arm's-length, written management agreement, as if they were cotrustees. If such an agreement cannot be reached, the trustee can sell the trust's share to the beneficiary, purchase the beneficiary's share, or, by agreement, put the property on the market. If there is no agreement on any of these options, the trustee may be forced to consider a partition action in order to protect the trust's interests. Prob C §17200. CCP §§872.010-874.240.

The same considerations of appearance of propriety, disclosure, and caution apply here as in the case of self-dealing. Situations in which the trustee participates with the beneficiaries or self-deals inherently call into question a trustee's duty of loyalty.

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§5.13 7. Duty to Dispose of Unproductive Assets

The trustee has a duty to make trust property as productive as possible under the circumstances and in furtherance of the purposes of the trust. Prob C §16007. Within a reasonable time after receiving trust assets, the trustee has the duty to review whether each asset should be retained or disposed of to comply with the purposes, terms, distribution requirements, and circumstances of the trust. Prob C §16049.

Under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054), an asset may be productive either by producing current income or by appreciating in value. Therefore, the trustee must determine whether a non-income-producing asset, *e.g.,* unimproved real property or beneficiary-occupied residential property, is appropriate for the trust and corresponds to the settlor's intent, the overall circumstances of the trust, and the needs of both the income and remainder beneficiaries. See *Estate of Gross* (1963) 216 CA2d 563, 31 CR 281. The trustee should dispose of unproductive assets in a manner that is impartial and fair to all beneficiaries.

If the trust instrument expressly requires retention of an unproductive asset, or directs the acquisition of such an asset, the trustee must follow that directive, and may do so without incurring liability. See Prob C §16046(b) (trust provisions may broaden or restrict application of prudent investor rule). However, if the trustee has been directed to retain an asset but determines that changed circumstances warrant its disposition, the trustee should consider a Prob C §17200 petition to the court for instructions, in furtherance of the purposes of the trust. Notice to creditors of the trust (or creditors of the settlor if the trust has become irrevocable on the death of the settlor) may be required if those creditors have filed a request for special notice in the on-going trust proceeding. Prob C §17204(b)(2)-(3) in conjunction with Prob C §17200(b)(5) or (6). See §15.40C.

Unproductive properties that may usually be held without breach of the trust include "family heirlooms" (jewelry, antique furniture) that the settlor wants passed down to another generation and property held in a trust that is due to terminate shortly. Occasionally, the trustee will receive "difficult to market" assets of small value relative to the trust corpus as a whole (*e.g.,* nonproductive limited partnerships or unleased gas or mineral rights). The trustee should have these assets professionally valued to determine whether they are likely to produce income in the future. If it is unlikely that these assets will ever be productive, and they essentially become unmarketable, the trustee should consider writing the asset off. The trustee should advise the beneficiaries of the proposed action (consistent with the duty to report), together with giving the beneficiaries the basis for the action. In particular cases the trustee may consider sending an official notice of proposed action or petitioning the court for approval to write the asset off, distribute the assets to the remainder beneficiaries, or to retain the assets with the acknowledgement that these assets will very likely never be productive.

Note that under limited circumstances the trustee may make an adjustment between principal and income to compensate income beneficiaries for holding underproductive property. Prob C §16336. See chap 8.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.14 C. Investment and Management Powers

§5.14 C. Investment and Management Powers

Under Prob C §16200, a trustee has the following powers without the need to obtain court authorization:

- Powers conferred by the trust instrument (see §5.15);
- Except as limited in the trust instrument, powers conferred by statute (see §5.18); and
- Except as limited in the trust instrument, the power to perform any act that a trustee would perform for the purposes of the trust under the standard of care provided in Prob C §16040 or §16047 of the Uniform Prudent Investor Act.

The grant of a power to a trustee, by the trust instrument, statute, or the court, does not in itself require or permit the exercise of that power. Each investment decision must be made with respect to the best interests of the beneficiaries (Prob C §16202) and to the prudent investor rule (Prob C §16047).

Because there are statutory investment powers, it is not necessary to have language in the trust instrument granting investment powers for a trust administered under California law. See Prob C §§16200-16249 and the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375).

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons)—the trust instruments must prohibit investments by the trustee other than those permitted under Prob C §2574. Cal Rules of Ct 7.903(a)(1), (c)(4) (Probate).

A statutory power to purchase a particular type of investment, *e.g.,* a deposit by a corporate trustee in its own banking department, does not relieve the trustee of the duty to maximize investments and act prudently in deciding whether each investment is appropriate. See *Conservatorship of Pelton* (1982) 132 CA3d 496, 183 CR 188 (deposit in corporate banking department).

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1. Powers Conferred by Trust Instrument

§5.15 a. Trust Instrument Language Following Former Statute

Older trust instruments frequently have an investment clause restating the prudent person rule as it previously existed when the trust instrument was drafted. This language now operates to permit any investment or strategy permitted under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054). Prob C §16053.

Restatement of the older prudent person rule in the instrument will not be considered a limitation by the settlor on the UPIA. To limit the trustee's investment standards, the settlor would have to include express language in the instrument. Prob C §16046(b).

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§5.16 b. Broad Investment Powers

The trust instrument may broaden the statutory standard of care set forth in Prob C §16047. Prob C §16046(b). Language broadening investment powers should protect the trustee from liability for making authorized types of investments if the trustee, in so doing, relies in good faith on the trust instrument. Prob C §16046(b). Broader language does not, however, absolve the trustee from meeting the prudent investor standard of care, *i.e.,* the trustee must still investigate the soundness of the investment and later manage it prudently. Prob C §16202; *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644; *Estate of Talbot* (1956) 141 CA2d 309, 296 P2d 848. In addition, a grant of absolute discretion does not absolve the trustee from acting prudently. Prob C §§16080-16081. See *Coberly v Superior Court* (1965) 231 CA2d 685, 42 CR 64.

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§5.17 c. Limited Investment Power

The trust instrument may limit the trustee's investment powers by restricting the types of permissible investments. Prob C §16046(b); *Stanton v Wells Fargo Bank & Union Trust Co.* (1957) 150 CA2d 763, 777, 310 P2d 1010, 1019. When the trust instrument provides that the trustee can invest only in specified investments, the trustee must follow that provision. Prob C §16000. The trustee may in good faith rely on these provisions (Prob C §16046(b)), but should not do so if the trustee believes that the directions are imprudent due to a change in circumstances. For example, when the trust instrument provides that the trustee may invest only in government bonds, the trustee must follow this direction unless it is imprudent to do so or unless the trustee believes that the restriction prevents the trust from fulfilling its express purpose. In that case, the trustee should petition the court to modify the instrument. See Prob C §16201. However, the trustee or other petitioning party has the burden of proving that the proposed modification of a restriction in the trust instrument is in the best interest of all trust beneficiaries. *Stanton v Wells Fargo Bank & Union Trust Co., supra*. On petitioning for modification, see chap 16.

If the trust instrument provides that the trustee must follow the law of another state regarding investments, the trustee is bound by that provision. The trustee will need to investigate the relevant laws in that state, both statutory and case law. See Prob C §16000. See Prob C §§17450-17457 on transferring the jurisdiction of the trust to California.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.18 2. Powers Conferred by Statute

§5.18 2. Powers Conferred by Statute

The specific statutory powers granted to the trustee regarding investment and management decisions include the power to:

- Collect and hold property (Prob C §16220);
- Receive additions to the trust (Prob C §16221);
- Participate in the operation of a business (Prob C §16222);
- Invest in obligations of the United States government (Prob C §16224);
- Deposit trust funds in various types of financial institutions (Prob C §16225);
- Acquire and dispose of property (Prob C §16226);
- Manage, control, divide, develop, improve, exchange, partition, change the character of, or abandon trust property or any interest therein (Prob C §16227);
- Encumber, mortgage, or pledge trust property (Prob C §16228);
- Subdivide or develop land (Prob C §16230);
- Enter into a lease (Prob C §16231), and enter into a lease or arrangement for exploration and removal of gas, oil, or other minerals or geothermal energy (Prob C §16232);
- Grant options (Prob C §16233);
- Exercise voting rights with respect to corporate shares, memberships, or property (Prob C §16234);
- Hold securities in the name of a nominee (Prob C §16238);
- Deposit securities in a securities depository (Prob C §16239);
- Insure trust property (Prob C §16240);
- Borrow money (Prob C §16241);
- Pay, settle, or release a claim (Prob C §16242);
- Make loans to a beneficiary (Prob C §16244); and
- Delegate investment functions (Prob C §16052).

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§5.19 3. Power to Delegate Investment Functions

The Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) permits a trustee to delegate investment and management functions as prudent under the circumstances. Prob C §16052(a). In fact, depending on the size of the trust and the complexity of the assets, it may be crucial for an unskilled trustee to consult with investment counselors, real estate brokers, accountants, tax attorneys, and other specialists. If a trustee decides to delegate investment or management responsibilities, the trustee must exercise prudence in (1) selecting the agent, (2) establishing the scope and terms of the delegation of authority, and (3) periodically reviewing the agent's overall performance and compliance with the terms of the delegation. Prob C §16052(a).

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D. Trustee Liability

§5.20 1. For Trustee's Own Actions

Probate Code §16051 states that compliance with the prudent investor rule of Prob C §16047 is determined in light of the facts and circumstances existing at the time the decision was made and not by hindsight. A loss to the trust will not be chargeable to the trustee if the trustee acted prudently under the circumstances in making and reviewing the trust investments. *Estate of Pitzer* (1984) 155 CA3d 979, 202 CR 855; *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644.

In *Collins,* the court noted that trust language holding the trustee harmless from liability for retaining an investment or following advice received from an investment advisor will be strictly construed. *Estate of Collins, supra*. The court in *Collins* surcharged the trustees for the loss of two-thirds of the trust funds invested in a second deed of trust. The first deed of trust was foreclosed because of a decline in real estate construction. The court stated that the trustees acted imprudently when they made the investment and therefore could not rely on changed economic circumstances to relieve themselves of liability. The prudent person rule requires the trustee to make a reasonable investigation into the investment and continue to monitor it. In *Collins,* the court found the trustees had not documented their efforts to investigate adequately the investment in the trust deed.

For a court decision upholding the exercise of trustee discretion as in compliance with the Uniform Prudent Investor Act (UPIA) in light of the facts and circumstances existing at the time of the decision in question, see *In re Stuart Cochran Irrevocable Trust* (Ind App 2009) 901 NE2d 1128, in which the court approved the trustee's exercise of discretion in surrendering existing insurance policies and procuring replacement policies with reduced death benefits. The trustee obtained and relied on independent insurance advisors' opinions, together with the trustee's own analysis of the economic viability of the existing policies and the ability of the settlor to continue to contribute sufficient amounts to the trust to pay ongoing premiums.

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§5.21 2. For Agent's Actions

Under Prob C §16401, the trustee's liability for the acts of an agent is limited, assuming the trustee (1) uses reasonable prudence in selecting an agent, (2) periodically reviews the agent's overall performance and compliance with the terms of delegation, and (3) takes reasonable steps to redress any wrongs on learning of an agent's act or omission.

Under Prob C §16401(b), a trustee is not liable for the acts or omissions of an agent employed by the trustee in the administration of the trust unless the trustee:

- Has the power to direct the act of the agent;
- Delegates to the agent the authority to perform an act that the trustee is under a duty not to delegate;
- Fails to use reasonable prudence in the selection or retention of the agent;
- Fails to periodically review the agent's overall performance and compliance with the terms of the delegation;
- Conceals the act of the agent; or
- Fails to take reasonable steps to compel the agent to redress the wrong when the trustee knows of the agent's acts or omissions.

A trustee found liable for the acts or omissions of an agent is liable for any loss or other adverse consequences affecting trust property as a result of the act or omission of the agent, if that act or omission would be a breach of the trust if committed by the trustee. Prob C §16401(b).

Under Prob C §16052 of the Uniform Prudent Investor Act, and except as otherwise provided in §16401, a trustee who complies with the provisions of §16052(a) (including conducting a periodic review of the agent's actions and monitoring the agent's performance and compliance with the scope and terms set forth in the engagement of the agent; see §5.35) is not liable to the beneficiaries for decisions or actions of the agent. Prob C §16052(c). This protection excludes situations in which the trustee knows of the agent's acts or omissions and either conceals them or neglects to take reasonable steps to correct any wrongdoing. The collapse of the security and real estate markets that occurred in September 2008 and thereafter is a reminder that investments do carry risk and even a diversified portfolio is not immune from systemic risk.

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II. PRACTICAL ASPECTS OF INVESTMENT AND MANAGEMENT OF ASSETS: AN OVERVIEW

§5.22 A. Initial Responsibilities

After appointment, the trustee should

- Locate and take possession of the trust assets (see Prob C §16006);
- Transfer title to the assets into the trustee's name; and
- Within a reasonable time of accepting the trusteeship or receiving the assets, review the assets and make and implement decisions concerning the retention and disposition of assets so as to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust and with the requirements of Prob C §§16000-16105. Prob C §16049.

NOTE: Probate Code §16049 does not define what constitutes a reasonable time. "Reasonable" would seem to be defined in terms of the trustee's skills and education, the nature of the trust assets, and the particular circumstances. For example, a reasonable period of time to review a portfolio consisting of bank accounts would be considerably less than what would be reasonable in reviewing a portfolio containing income-producing real property, unimproved real property, and securities.

PRACTICE TIP: Documentation of the initial review of the trust, as required under Prob C §16049, and proof of consideration of the trust circumstances under Prob C §16047(c) become important should there be a challenge, at a later date, to a trustee's decision or action.

A national bank trustee must "promptly" review the assets after accepting a fiduciary account for which the bank has investment discretion. 12 CFR §9.6(b). Office of the Comptroller of the Currency Fiduciary Precedent 9.4103 states that the initial review should be made within 60 days of funding. For national banks, the Office of the Comptroller of the Currency requires two stages of investment review. The first is an individual account review to consider the basic merits, suitability, and legality of investments in the trust corpus. The second stage is a review of the nature and security of the individual assets. Office of the Comptroller of the Currency Fiduciary Precedents 9.4102. For further discussion of the trustee's duty with regard to original investments, see Restatement (Third) of Trusts §92 (2007).

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.23 B. Developing an Investment Strategy

§5.23 B. Developing an Investment Strategy

After reviewing the assets, the trustee should develop an investment strategy that complies with the prudent investor rule. The strategy should be appropriate to the needs of each class of beneficiaries in light of any specific statement of priority in the trust document. The trustee should consider whether diversification, disposal, or other immediate investment action is required. The nature of the trust terms, or of the trust assets, may be such that the trustee will consider hiring investment advisors, which is permitted under Prob C §16052. For discussion of delegation, see §5.33.

NOTE: The trustee should begin to make needed investment changes as soon as possible, considering the cash needs of both the beneficiary and the trust itself. To prevent delinquency and default, the trustee should compile and calendar a list of due dates for trust debts and liabilities, *e.g.,* note payments. The trustee should also consider making a regular schedule for paying income beneficiaries.

The importance of maintaining adequate records for the trust cannot be overemphasized. The attorney should advise the trustee to prepare a written statement regarding this initial analysis that can be produced, if necessary, at a later date. Documentation of the initial review of the trust under Prob C §16049 and proof of consideration of the trust circumstances under Prob C §16047(c) become important if a trustee's decision or action is challenged at a later date. In every case, it is important for the trustee to make and retain notes regarding the investment decisions, including the decisions about retaining or selling assets, and to document the trustee's consideration of his or her duty to diversify. See chap 7.

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1. Standard of Care When Making Investment Decisions

§5.24 a. Uniform Prudent Investor Act

The Uniform Prudent Investor Act (UPIA) (Prob C §16047(c)) specifically directs the trustee to consider the following factors in making investment and management decisions:

(1) General economic conditions.
(2) The possible effect of inflation or deflation.
(3) The expected tax consequences of investment decisions or strategies.
(4) The role that each investment or course of action plays within the overall trust portfolio.
(5) The expected total return from income and the appreciation of capital.
(6) Other resources of the beneficiaries known to the trustee as determined from information provided by the beneficiaries.
(7) Needs for liquidity, regularity of income, and preservation or appreciation of capital.
(8) An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

The trustee should also consider the purpose and probable duration of the trust and the total size of the trust estate.

Probate Code §16047(d) requires the trustee to make a reasonable effort to verify facts relevant to investment and management that presumptively apply to the factors listed in Prob C §16047(c). The attorney for the trustee should advise the trustee to keep a checklist of the circumstances listed in Prob C §16047(c) and to note next to each item that the trustee has considered it and whether it applies.

Probate Code §16000 requires the trustee to act to accomplish the purposes of trust. In doing so, the trustee may now consider individual investments as part of an overall investment strategy. A trustee can invest a portion of the assets in speculative investments, provided that the overall portfolio investment mix is prudent. Prob C §16047(e).

NOTE: The requirements of the UPIA can be expanded, restricted, eliminated, or altered by the provisions of the trust, and the trustee is not liable to a beneficiary to the extent the trustee acts in reasonable reliance on the trust provisions. Prob C §16046(b).

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§5.25 b. Restatement (Third) of Trusts

The prudent investor rule is adapted from the Restatement (Third) of Trusts §§90-92 (2007) (originally published in 1992) and was formulated to direct the trustee to consider the effects of inflation and to evaluate the relative risks and rewards of the trust portfolio as a whole, in accordance with the body of research known as modern portfolio theory (MPT). A detailed description of MPT is beyond the scope of this chapter, but the trustee may find it helpful to review the comments to the Restatement.

The Restatement established the following "principles of prudence" to be considered in managing trust investments:

- No investment or technique is imprudent per se.
- Diversification is fundamental to risk management and ordinarily will be required of a trustee.
- Risk and return are so directly related that trustees have a duty to analyze and make conscious decisions concerning levels of risk appropriate to trust purposes.
- Trustees have a duty to avoid unjustified costs.
- The fiduciary duty of impartiality between classes of beneficiaries requires balancing production of current income and the protection of purchasing power (as opposed to nominal value).

Trustees should have the authority to delegate, as a prudent investor would, the management of assets to an agent who has knowledge of and experience with MPT.

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§5.26 2. Suitable Investment Strategies

An appropriate investment strategy should take into consideration the specific circumstances of the trust and its beneficiaries. Investing for a generation-skipping trust with sprinkling provisions, for example, will require an investment strategy different from one that is required to provide present and ongoing payments to beneficiaries. The trustee should also be aware of how current tax law applies to the trust: A trust that is required to accumulate income will have different tax consequences, and perhaps therefore a different investment strategy, than will be required for investments in a wasting trust. A trust that will terminate to taxable individuals may have a different strategy than a charitable remainder trust.

In developing an investment plan, the trustee should consider, in addition to the factors listed in Prob C §16047(c) (see §5.24), the costs of various investments. A trustee may incur only costs that are appropriate or reasonable for the assets, overall investment strategy, purposes, and other circumstances of the trust. Prob C §16050. If a trustee is considering an investment strategy employing mutual funds, the trustee should have a thorough understanding of the ongoing management fees, including any load fees or transaction fees that may apply, and should also consider comparing the total fees of different families of mutual funds. These fees can vary considerably. The trustee should document this evaluation as part of the permanent investment records. Similarly, if a trustee is hiring an investment advisor, the trustee should document that the fees paid to the advisor are typical of the current standard for management fees.

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3. Considerations Regarding Retaining Assets

§5.27 a. Power to Retain Assets

Probate Code §16049 provides that, within a reasonable time after accepting the trusteeship or receiving trust assets, a trustee must review the trust assets and decide whether to retain them or dispose of them. Therefore, the trustee must not fail to evaluate the assets periodically to decide whether it is in the best interests of the beneficiaries to retain them. *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644.

Probate Code §16220 gives the trustee authority to retain any trust asset as long as the retention is in the best interests of the trust or in furtherance of the purpose of the trust, unless the trust instrument specifically provides otherwise. Thus, the trustee may retain assets even if the instrument does not expressly authorize the trustee to do so. Trust instruments seldom prohibit retaining assets. More commonly, the instruments follow the language of the retention statute.

The trust instrument may give the trustee greater discretion to retain assets than is provided by statute. Prob C §16000. Even with an absolute-discretion provision, however, the trustee must follow fiduciary principles under Prob C §§16080-16081. Unless the trust states that the trustee may not retain improper investments, the trustee may do so if it is in the best interests of the trust or in furtherance of the purposes of the trust. It seems clear that it would be an unreasonable exercise of discretion to retain an improper investment that is not in the best interests of the trust. See Prob C §16047(c) for factors to consider in investing trust assets. See also *Coberly v Superior Court* (1965) 231 CA2d 685, 42 CR 64. On trust instrument provisions that require retention, see §5.28.

NOTE: As a practical matter, the trustee may have little choice but to retain an asset for which there is no market, even though he or she would otherwise dispose of it.

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§5.28 b. Required Retention

The trust instrument may require the trustee to retain assets. Prob C §16046(b) (trust instrument may expand or restrict investment powers). The trustee's potential liability for retaining the assets is minimized when the instrument specifies the particular asset or assets to be retained and sets out the reason for retention. For example, the instrument may direct the trustee to retain stock of a closely held family business, specified real property, or specified personal property because the settlor wants to pass the asset to succeeding generations. Alternatively, the instrument may require the trustee to keep the entire estate intact because the settlor believes that the portfolio he or she has built will protect the beneficiaries better than any investments the trustee could make.

The instrument may require either permanent retention or retention for as long as the trustee believes it does not defeat the purposes of the trust. The trust instrument language determines the scope of the trustee's duty; if the language is vague or ambiguous, the trustee should petition the court for clarifying instructions. On petitioning for instructions, see chap 15.

Even when retention of assets is mandated, the trustee should review the assets periodically. A failure to review and to act appropriately may be imprudent if the assets decline substantially in value. When the trust instrument mandates retention and the trustee believes retention to be imprudent, the trustee should petition the court for a modification of the instrument. The trustee should not dispose of such assets without court approval. See Prob C §16201. On modification in court, see chap 16. Even if denied, a petition to modify may help to protect the trustee against later claims of imprudence in retaining the asset, assuming circumstances have not materially changed. On documenting investment decisions, see chap 17.

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4. Considerations Regarding Diversification

§5.29 a. Risk Management

Diversification is fundamental to risk management and is therefore an integral factor in prudent investment management. See Ellis, Hartog, Wolf & Gifford, *Issues in Trust Administration and Experiences of Professional Trustees: Applying Prudent Investor Act and Principal and Income Act Adjustment Powers*, Estate Planning 2005, chap 9 (Cal CEB 2005). The trustee should understand and evaluate the various risks that apply to portfolio management:

- Market, or systemic, risk (the risk that a diversified portfolio will not produce the expected return);
- Unique, or unsystemic, risk (the risk associated with a specific issue in the portfolio, such as a company's decision to file for bankruptcy);
- Interest rate risk (the risk that interest rates will change, which can affect the current market value of fixed-income instruments, as well as valuations for stocks); and
- Risk of inflation (the risk that the purchasing power of the portfolio, or the income distributed from the portfolio, will not keep pace with price changes).

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.30 b. Factors Relevant in Assessing Adequacy of Diversification

§5.30 b. Factors Relevant in Assessing Adequacy of Diversification

Among others, the trustee should consider the following factors in deciding whether the trust assets are properly diversified:

- Size, terms, and purpose of the trust;
- Representation of different asset classes;
- Correlation of returns between the different asset classes;
- Needs of the beneficiaries and the type of return produced by each investment;
- General economic conditions;
- Volatility of each asset and the percentage of trust corpus that the asset represents;
- Percentage of the total company that the trust holds;
- Market for the asset; and
- Tax planning implications.

NOTE: If the trustee is uncertain about whether the trust assets are properly diversified, or whether the trustee has properly evaluated the risk management of the portfolio, the trustee might consider consulting with an investment advisor. For discussion of rules on delegation, see §5.33.

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§5.31 c. When Diversification May Be Limited or Unnecessary

On occasion, it may be imprudent to diversify. For example, the trustee is probably not under a duty to diversify if the trust is extremely small or has a very short time horizon or if general economic conditions are so unstable that the trustee is wise to invest all the trust funds in a single safe asset (*e.g.,* a fixed-income government security).

Although Prob C §16048 generally requires a trustee to diversify the investments (see §5.8), the trustee may determine that, due to special circumstances, the purposes of the trust are better served by not diversifying. For example, the trust may consist solely of a single parcel of improved real estate with a low cost basis and an anticipated short duration of the trust, at which time the property will receive a stepped-up basis. The trustee may determine that, because of these special circumstances, the investment should be retained until a new basis is available and the asset can be sold without incurring substantial capital gains taxes. As another example, the trust instrument may require the trustee to retain a particular asset that may affect the trustee's ability to diversify the total portfolio.

The trustee probably need not reduce an otherwise prudent holding simply because it has increased dramatically in value, and thus represents a larger portion of the total value of the trust estate, if the trustee still believes that the investment is a sound one and appropriate for the trust's objectives. See Restatement (Third) of Trusts §90, Comment g (2007). However, the presence of this concentration must be reviewed regularly and weighed against the overall duty to diversify.

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§5.32 d. Effect of Nondiversification Clause in Trust

The trust instrument may state that the trustee has no duty to diversify. Prob C §16046(b) (trust may broaden trustee's investment powers). It is not clear, however, whether a trustee may rely on such a provision if nondiversification conflicts with the trustee's duty to act prudently. There is no California case law that resolves this question, but it is a commonly encountered problem. Although *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473, involved a will that gave the trustees discretion not to dispose of certain businesses regardless of the income produced "unless it shall in their opinion be necessary or prudent to do so," the court did not directly address the effect of that nondiversification provision because the litigated issue was the enforceability of the no-contest clause. In *Americans for the Arts v Ruth Lilly Charitable Remainder Trust* (Ind App 2006) 855 NE2d 592, the court held that the trustee did not have a duty to diversify trust assets because the trust document expressly conferred a power to retain indefinitely trust assets and further declared that "any investment retained in good faith shall be proper despite any lack of diversification." In *Wood v U.S. Bank* (Ohio App 2005) 828 NE2d 1072, the court held that a general power to retain investments did not override duty to diversify. However, the court noted that the settlor *could* have eliminated the duty to diversify—he simply did not do so.

An investment in a high-risk asset may be prudent in small amounts in a large trust when it is balanced by more stable and conservative investments, but imprudent if it comprises a major portion of the value of the trust. In that case, it could be argued that the trustee has a duty to avoid the high-risk asset regardless of nondiversification provisions in the trust instrument. In a similar case, the court in *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644, found that discretionary provisions in the trust instrument did not protect the trustee from liability for failure to diversify.

If the assets that constitute a concentration are part of the original trust estate and the trust instrument authorizes or directs nondiversification, it is arguable that the trustee may rely more confidently on a nondiversification clause because the settlor knew of this concentration and nonetheless authorized nondiversification. See *Stark v United States Trust Co.* (SD NY 1978) 445 F Supp 670. However, boilerplate nondiversification language may be subject to greater challenge than language expressly authorizing retention of a specific asset, particularly if the reason for retaining the asset is stated.

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§5.33 C. Delegating Investment Functions

The Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) permits a trustee to delegate investment and management functions as prudent under the circumstances. Prob C §16052(a). In fact, depending on the size of the trust and the complexity of the assets, it may be crucial for an unskilled trustee to consult with investment counselors, real estate brokers, accountants, tax attorneys, and other specialists. If a trustee decides to delegate investment or management responsibilities, the trustee must exercise prudence in (1) selecting the agent, (2) establishing the scope and terms of the delegation of authority, and (3) periodically reviewing the agent's overall performance and compliance with the terms of the delegation. Prob C §16052(a).

Ideally, the agent will have experience managing investments for fiduciary entities and will be able to accommodate any specific directions set forth in the instrument, such as allocation of fees, amortization of bonds, or a prohibition against invasions of corpus.

In establishing the scope and terms of the delegation, the trustee and the agent should prepare written guidelines that include:

- A summary profile of the trust and its purposes;
- The investment objectives for the assets delegated to the agent, including a statement of risk tolerance;
- Asset allocation targets;
- A description of acceptable asset class characteristics;
- A description of how performance will be measured;
- Income and/or cash flow requirements for the beneficiaries;
- Investment time horizon;
- Other liquidity needs for the trust for payment of taxes, fees, or other expenses;
- A description of the tax status of the trust; how taxes are allocated, and whether there are any special restrictions on trust investments as a result of the trust's tax status;
- An agreement of how transactions will be reported to the trustee; and
- Ideally, a summary description of how communications will be transacted between the agent and the trustee and how investment transactions will be approved.

If the assets are relatively small, the trustee may choose to delegate the investment management responsibilities to a manager of mutual funds. The trustee should take great care to understand the general description of investment objectives, asset classification, and individual risks inherent in each mutual fund employed. The trustee should work with the trustee's tax advisor to periodically reconcile mutual fund statements, ensuring that capital gain distributions are properly allocated.

It is important to remember that the provisions of the UPIA extend beyond the management of financial assets and affect the management of any assets that are a part of the trust account, including real property and collections of tangible items.

NOTE: In performing a delegated function, an agent has a duty to exercise reasonable care to comply with the terms of the delegation. Prob C §16052(b). An agent who accepts a delegation of a trust function from the trustee, in California, submits to the jurisdiction of the courts in this state. Prob C §16052(d). This section is apparently aimed at those situations in which an out-of-state agent, such as an investment advisor or property manager, is employed by a California trustee.

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§5.34 D. Balancing the Interests of Different Classes of Beneficiaries

In some cases, one or more of the adult remainder beneficiaries may ask the trustee to seek maximum income even though such a strategy is detrimental to the remainder interest. This typically occurs when the trust requires the distribution of net income each year and the income beneficiary is the parent of the remainder beneficiaries. Although such a request is evidence of those beneficiaries' desires, the trustee cannot rely only on their desires to defend against imprudence. Most trusts require that remainder beneficiaries survive to take their interests. If any of those who sought the maximum income die before the trust terminates, the trustee may be challenged by other remainder beneficiaries who, having lost their expectancy, question the prudence of the investments. See §7.36A for form letter to trustee objecting to investment strategy.

It may be appropriate, absent any contrary authority in the trust instrument, for the trustee to direct investment and distribution to the extent possible as a unitrust. Instead of distributing net income to the beneficiary and trying to obtain an adequate return by constantly juggling equity and fixed-income instruments, the trustee should consider distributing a percentage of the trust corpus (income and principal) to the income beneficiary each year in lieu of net income. The trustee can approximate this result by using the Prob C §16336 adjustment power to reallocate a portion of trust principal each year to income, which is then distributed to the income beneficiary. However, the adjustment power cannot be used if the trustee is a beneficiary of the trust, and the trustee must make sure that the income interest of a spouse is not diminished. Further, some remainder beneficiaries may question the trustee's use of the adjustment power.

Alternatively, the trustee can convert the income interest into a unitrust interest under Prob C §§16336.4-16336.7. An income interest can generally be converted into a unitrust interest without court approval if the payout percentage is 4 percent and no beneficiary objects. See §8.3E. By distributing a percentage, the investment strategy focuses on total return (a combination of appreciation and income). The greater the total return, the greater the opportunity for growth, which benefits both income and remainder beneficiaries as each realizes greater returns from an appreciating trust over time.

EXAMPLE: If the trust achieves a total return of 10 percent per year and 4 percent of the trust corpus is distributed to the income beneficiaries, the trust grows by 6 percent.

Total return trusts are a 1990s phenomenon that arose in response to both stock market appreciation and the tensions inherent in blended families in which surviving spouses and remainder beneficiaries (the deceased spouse's children from an earlier marriage) are not related at all and do not have similar views.

Most unitrust formulas average returns over 3 years to ameliorate yearly fluctuation. The unitrust conversion statute generally requires distributions to be based on the net fair market value of trust assets as determined annually, averaged over the lesser of the 3 preceding years or the life of the trust. Prob C §16336.4(e). The experience of the early 2000s suggests that too much reliance on growth, even in a unitrust, may adversely affect an income beneficiary —a portion of the portfolio must be directed toward income. For example, sole reliance on growth assets for 2000, 2001, and 2002 would not have benefited an income beneficiary who saw fair market values plummet during that period. A possible alternative to relying solely on the unitrust approach for a trust that has not been converted is to distribute to the spouse or other income beneficiary an amount equal to the "greater of net income or the unitrust percentage." However, the trustee may not reconvert a unitrust or change the payout percentage without a court order until 3 years after the most recent conversion to a unitrust. Prob C §16336.6.

If a unitrust approach is taken, an appropriate percentage should be used to allow continued growth. Generally, a payout percentage of 4 percent is considered feasible. A higher percentage may result in depletion of the trust. The conversion statute permits a payout percentage of not less than 3 percent and not more than 5 percent of the fair market value of trust assets if all parties agree or a court orders the conversion. Prob C §16336.5.

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E. Periodically Reviewing Investments

§5.35 1. In General

There is no specific statutory or case law requirement for periodic review of trust investments. However, prudent management dictates that trust investments be reviewed at regular intervals and not just at the outset of the trustee's administration. The purpose of the periodic review is to determine whether to retain or dispose of any trust asset. The trustee should first consider the particular needs of the beneficiaries and the structure of the trust, and then consider whether the mix of assets and the overall asset allocation continues to be suitable for the trust. Prob C §§16007, 16047(c). The trustee should then consider whether changed economic conditions warrant a change from the strategy set forth in the initial review or a previous periodic review. For example, when the trust is intended to provide for a lifetime beneficiary, the trustee will want to examine the historical and projected disbursements from the trust and evaluate whether the current level of payments can continue without harm to the corpus of the trust.

The trustee should further examine each asset in the trust and evaluate, when considering the portfolio as a whole, whether the asset should be retained. For example, if the trustee learns that a bond or other fixed-income investment has been downgraded by a rating service, the trustee must weigh the benefits of maintaining the current coupon and the principal risk of having the bond default against replacing the current coupon rate and the tax consequences of selling the bond. Similarly, if a trust holds a commercial property asset that has declined in income stream or total value, the trustee should evaluate whether to improve the property, sell it, or exchange it for a similar asset.

The trustee should be constantly aware of changed economic conditions affecting trust investments. The periodic investment review is an opportunity to pay close attention to each trust asset in light of current trends.

PRACTICE TIP: It may be convenient and logical to perform the review just before the close of the year. The trustee will benefit from convening a team of advisors, including an investment advisor (if one has been hired), accountant, and attorney, to review the consequences of any proposed action. It seems good practice for the attorney or trustee to determine the effect of tax decisions on the income beneficiaries by discussing with them their current tax situation. It is important for the trustee to maintain a written record of what was discussed at these periodic reviews. These records will provide evidence of the trustee's good faith and prudent review if a particular investment is challenged at a later date.

Many corporate trustees are required to make periodic investment reviews. See 12 CFR pt 9. All assets of each fiduciary account for which the bank has investment discretion must be reviewed at least once each calendar year. 12 CFR §9.6(c).

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§5.36 2. Method of Review

The first step in reviewing the assets is to update information on the financial needs of the beneficiaries. For methods of maintaining current information about beneficiaries, see chap 7. The trustee should also review any correspondence and other memoranda or notes about trust assets that were added to the trust records since the last review. For example, if a trustee retains an investment advisor, the trustee should keep statements of the assets from the manager or custodian, copies of reviews that were conducted jointly by the trustee and investment advisor, and notes regarding decisions made during those meetings.

For individual trustees who keep a separate file folder for each investment or each major category of investment, the review process should be fairly simple. The trustee should make periodic personal inspections of any real estate owned by the trust to determine whether to retain or dispose of the property. When inspection is difficult due to the location of the property, the trustee may delegate this duty to a professional appraiser who will make a written report to the trustee. Real property inspections should include a review of the physical condition of the property, the adequacy of insurance coverage, lease compliance by lessees, the general appearance of the neighborhood, and any other issues affecting the current and future value of the property. For further discussion of real property management, see §5.47.

The trustee should personally inspect tangible personal property that is stored or held on consignment.

The trustee should maintain a written record of these inspections, noting the inspection date, the trustee's impressions of the property's condition, and any other considerations affecting a decision to retain or dispose of the property. These reports should be kept in the appropriate asset file.

For full discussion of recordkeeping requirements and suggestions, see chap 7.

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§5.37 III. MANAGING SPECIFIC TYPES OF INVESTMENTS

An in-depth discussion of all possible trust investments and their tax consequences is beyond the scope of this book. See §§5.38-5.97 regarding management of some of the most commonly held types of trust assets.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.38 A. Cash or Cash Equivalents

§5.38 A. Cash or Cash Equivalents

When making cash investments, trustees should consider both the security of funds and the interest rates they earn. Unless the trust instrument provides otherwise, a trustee may deposit trust funds in an interest-bearing account to the extent that the account is federally insured. Prob C §16225. However, such an investment would have to comply with the prudent investor rule.

Deposits in bank accounts of up to $100,000 (plus cost-of-living adjustments beginning in 2010) are insured by the Federal Deposit Insurance Corporation (FDIC). The standard maximum deposit insurance amount (SMDIA) is temporarily increased from $100,000 to $250,000 until December 31, 2013. However, the insurance is calculated per owner at each institution, not per account. For these purposes, the insurance is calculated separately for "revocable trust accounts" based on the number of beneficiaries. Interim FDIC regulations provide that $500,000 of coverage is available if there are five trust beneficiaries—even if four of them receive $1 and the other beneficiary receives the balance. Insurance coverage continues for revocable trust accounts when the corresponding revocable trust becomes irrevocable despite rules that limit insurance coverage for irrevocable trusts to the amount of the "beneficiary's non-contingent trust interests." These rules apply to formal trusts ("living trusts") and informal trusts, such as pay-on-death (POD) accounts and "in trust for" (Totten Trust) accounts. These rules do not apply to trust accounts opened after the settlor's death. Accordingly, trustees should open or keep each bank account in the name of the trust, and avoid maintaining deposits of over $100,000 in new trust accounts or more than $500,000 (if there are five or more named beneficiaries) or more than $100,000 per beneficiary (if there are fewer than five named beneficiaries) in existing trust accounts at any one institution. 12 USC §1821(a); 12 CFR §§330.8-330.10, 330.13.

Investing trust funds with an insured savings and loan association or credit union is expressly authorized. Prob C §16225(a)(1)-(2). Investments in Treasury bills or notes that are guaranteed by the United States government are not specifically allowed but would probably be deemed prudent in the context of the trust portfolio as a whole and as a part of an overall investment strategy under Prob C §16047(b). They are specifically allowed without court approval for guardians and conservators (Prob C §2574) and personal representatives of decedents (Prob C §9730). If the governing instrument permits investments in obligations of the United States government, the trustee may invest in them directly or through a registered money market mutual fund. Prob C §16224.

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§5.39 1. Bank Trust Department as Trustee

A bank trust department may deposit trust funds with that bank itself, provided that the trustee has reserved adequate collateral securities for the funds. 12 CFR §9.10(b); Prob C §16225(b). Probate Code §16225(b) does not, however, exempt national bank trustees from their obligation to maximize the return on trust funds. *Conservatorship of Pelton* (1982) 132 CA3d 496, 502, 183 CR 188, 192. See Office of the Comptroller of the Currency Fiduciary Precedents 9.3205, which requires the trustee to obtain the highest rate of return that is prudent under the circumstances. If challenged, the bank-trustee that self-deals trust funds at a lower rate of interest than the funds would have earned elsewhere with similar safety and liquidity has the burden of proving that the deposit was prudent and reasonable. *Conservatorship of Pelton, supra*. The rule of *Pelton* is that, once the bank-trustee has established the appropriate type of investment, the trustee then has the further burden of proving that a deposit in its commercial banking department is reasonable, *i.e.,* that the rate of interest offered is competitive. See also OCC Fiduciary Precedents 9.3205.

The introduction of money market funds for fiduciary accounts by corporate trustees should reduce the burden on bank-trustees that self-deposit, but any such fund should pay market rates to avoid the problems of *Pelton*. OCC Fiduciary Precedents 9.3100 and 9.3205.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.40 2. Public Guardian or Administrator as Trustee

§5.40 2. Public Guardian or Administrator as Trustee

Probate Code §16042 sets out the standard of care regarding trust property held by the public guardian or administrator appointed as trustee of a trust under Prob C §15660.5. The funds may be deposited or invested in the same manner, and are subject to the same terms and conditions, as a public administrator's deposit or investment of funds in a decedent's estate under Prob C §§7640-7644. Prob C §16042(a). Generally, all funds must be deposited in an insured account in a financial institution or with the county treasurer. Once the funds are so deposited, the public guardian or administrator is deemed to have met the standard of care specified under the Uniform Prudent Investor Act (Prob C §§16045-16054). Prob C §16042(b).

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§5.41 B. Securities

For purposes of this discussion, "securities" include fixed-income investments, *e.g.,* bonds, and equities, *i.e.,* common stocks, as well as debentures, options, and futures. There are no statutory restrictions on securities investments for California trustees. The trustee simply must determine what is appropriate for the trust. Prob C §§16046(b), 16047(e). National bank trustees have certain restrictions on types of investments and the manner of engaging in these investments, although federal regulation generally permits the trustee to follow state law unless the trust instrument provides otherwise. See 12 CFR pt 9 and the Fiduciary Precedents thereunder. A bank may not invest in its own securities unless authorized by applicable law (defined in 12 CFR §9.2(b) to include state and federal law, terms of the governing instrument, and court orders). 12 CFR §9.12(a).

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§5.42 1. Purchases and Sales

If the trustee has not hired an investment manager on a fee basis, a broker should be employed to handle purchases and sales of securities. The investment management or brokerage account must be opened in the name of the trust using the trust's tax identification number. For example, the account name would read as follows: "The John and Judy Smith Trust dated 1/30/__, John Jones, Trustee." This identifies the assets in the account as trust assets. The trustee should avoid holding trust assets in his or her individual capacity.

An individual trustee may leave securities in street name and in a broker's custody, but national bank trustees are forbidden to do so. See Office of the Comptroller of the Currency Fiduciary Precedents 9.2050. If an individual trustee leaves the securities in a broker's care, he or she should make sure that the broker is insured (usually with the Securities Investor Protection Corporation) and leave on deposit only amounts within the insurance limits. The trustee should weigh the convenience of leaving securities in street name against potential losses due to delays in trading that may occur if the broker defaults. Even if the account is insured in full, insurance will not cover this type of loss, which could be substantial. There are no reported California decisions on whether a trustee is liable for such losses.

Opinions vary regarding the advantages of a full-service broker over a discount broker. Some investors believe the full-service broker's investment advice more than compensates for the added cost to the trust in commissions.

Corporate trustees often hold trust securities in the names of nominees to facilitate transfers. Nominees usually are partnerships, consisting of bank officers, whose sole purpose is to hold title and act on instructions of the corporate trustee. This practice is authorized by Fin C §1563 for corporate fiduciaries unless the trust instrument provides otherwise. An individual cofiduciary must consent to the use of a nominee. Prob C §16238, permitting the use of a nominee, applies to individual as well as corporate trustees.

For a discussion of a corporate trustee's investment in the company's own stock, see chap 2.

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§5.43 2. Trustee's Assumption of Shareholder Responsibilities

A trustee must exercise the full rights of a shareholder for securities held as trust assets. To do otherwise may be a breach of the trust investment management obligation. For example, the trustee has the authority to vote proxies on all securities held in trust whether or not the trust instrument expressly authorizes the trustee to do so. See Prob C §§16234, 16236-16237. Thus, the trustee's attorney should advise the trustee to vote in corporate elections that may substantially affect the company (*e.g.,* elections to merge or dissolve the company), because these elections may in turn affect the trust. Although there are no California cases on this issue, Scott suggests that the trustee is under a duty to vote in such a way as to promote the interests of the beneficiaries. See 3 Scott & Ascher on Trusts §18.1.8.1 (5th ed 2007). Failing to vote in routine corporate elections (*e.g.,* approving a slate of unchallenged candidates for the board of directors) is probably not imprudent, unless the trust holds a substantial block of shares in the corporation. When the trust is a substantial shareholder, failure to vote is not only a possible breach, it might also preclude a quorum, causing extra expense to the company and reduced profits to the trust. For a discussion of responsibilities of a trustee who holds a controlling interest, see §5.68 and 3 Scott & Ascher §§18.1.8.1-18.1.8.2.

Corporations Code §711 requires trustees voting stock on behalf of others to maintain records of the manner in which the shares are voted and to disclose the record on reasonable written request.

Most proxy solicitation matters are noncontroversial and the trustee's voting decision is not difficult. However, there may be issues on which the trustee holds strong personal views, *e.g.,* the company's policy on doing business with certain foreign countries. Unless the trustee's personal views coincide with the trust's economic well being or the settlor's express desires, the trustee must set aside personal views when voting the proxy.

If a trustee is voting in a proxy battle, *e.g.,* a takeover, the trustee should vote the shares in the best economic interests of the trust. If the proxy battle is sufficiently complex, the trustee should seek business advice and possibly legal advice as well.

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§5.44 C. Mutual Funds, Investment Trusts, and Other Group Instruments

There are many different kinds of funds in which the investor is given a proportional interest in a whole group of investments purchased with the collected funds of all the investors. Among this type are mutual funds, investment trusts, investment companies, collective trusts, and participating interest funds. Banks often manage common trust funds for their fiduciary accounts that are analogous to mutual funds. See §5.45. One increasingly common fund is the market or index fund, a group of equities selected to match one of the indexes of market performance, *e.g.,* the Standard & Poor's 500. The market index funds operate on the theory that over long periods of time they will perform better than a managed portfolio.

In the past, investing in mutual funds and the like was considered an improper delegation of authority because the trustee does not exercise control over the actual investment of trust funds, and an improper expense because both the trustee and fund manager receive fees for investing the same assets. Most state statutes now expressly permit trustees to invest in mutual funds. The general empowering statutes, Prob C §§16047 and 16052, permit a California trustee to make this kind of investment and the Law Revision Commission comments so state.

National bank trustees are permitted to invest in mutual funds if doing so is authorized by local law, the governing instrument, or express consent of all the parties. See Trust Banking Circular No. 4 (Sept. 29, 1976). Corporate trustees may also invest in mutual funds for which the trustee or an affiliate provides investment or management services. Fin C §1561.1. The statute requires prior notice to beneficiaries and imposes certain limitations on the trustee's compensation in such situations.

California law also expressly provides that trustees can legally purchase investment certificates of savings and loan associations and shares of an insured federal savings and loan association. See Fin C §7000. Investment in mortgage participations is also authorized. Ins C §12528.

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D. Common Trust Funds Operated by Corporate Trustees

§5.45 1. Definition and Statutory Authority

A common trust fund (also called a diversified investment fund, collective fund, or commingled fund) is formed when the corporate trustee pools the funds of its fiduciary accounts and purchases a group of investments, assigning each account a proportional interest (or unit) in the whole group of investments.

State law expressly authorizes and regulates the investment of trust assets in common trust funds. Fin C §1564. In addition, the Comptroller of the Currency regulates common trust fund investment by national banks acting as trustees. 12 CFR §9.18. Section 9.18 allows a national bank trustee to hold trust assets in common funds to the extent that the investment is consistent with applicable law (defined in 12 CFR §9.2(b) to include state and federal law, terms of the governing instrument, and court orders). 12 CFR §9.18(a). The section also establishes requirements for the proper administration of common trust funds. Although some corporate trustees are not regulated by the Comptroller of the Currency, IRC §584 requires all trustees to conform with the Comptroller's Regulations if the funds are not to be subject to an additional layer of income taxation. Despite these statutory and regulatory provisions, corporate trustees sometimes prefer that the trust instrument expressly authorize investment in common funds so that beneficiaries are aware that this was the settlor's intention.

Large corporate trustees often have numerous common trust funds, each with a different investment objective, *e.g.,* tax-exempt income funds, funds of common stocks to provide balanced income and appreciation, funds for capital appreciation only, and money market certificate funds to provide cash liquidity. Common funds allow corporate trustees to diversify trusts that would otherwise not be large enough to spread their assets economically across a broad investment spectrum.

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§5.46 2. Limitations and Drawbacks of Common Trust Funds

There are, however, a few pitfalls associated with common trust funds. Trust instruments may expressly prohibit investment in such funds; such directions must be followed. Prob C §16000. See Fin C §1564; 12 CFR §§9.2(b), 9.18(a). In addition to express prohibitions, language that limits the types of investments may indirectly preclude a trustee's participation in common trust funds. For example, if the trustee is directed to purchase only common stock that has a 10-year record of paying a quarterly dividend, that instruction would probably preclude the investment in many, if not most, common trust funds of common stocks, because there is likely to be at least one company in the fund that does not meet the requirement.

A national bank trustee may impose a reasonable charge for managing a common trust fund if the charge is permitted under applicable law and commensurate with the value of legitimate services of tangible benefit to the trust that would not have been provided if the trust assets had not been invested in the fund. 12 CFR §9.18(b)(9). Typically, however, corporate trustees charge a single management fee for the individual trust and do not charge a separate fee for managing a trust's participation in the common trust fund.

There are other drawbacks to using a common trust fund. The trustee produces a detailed report on the common fund only once a year. The monthly or quarterly trustee's report provides an overall valuation per unit of the common fund held. Additionally, individual investments provide remainder beneficiaries with greater flexibility in adjusting for the tax consequences on distributions of trust assets to them. Assets in a common trust fund cannot be distributed in kind. When the trust terminates, or the bank trustee resigns, or trust funds must be distributed to beneficiaries, the common fund units must be sold. This causes realization of capital gain or loss for tax purposes, often resulting in an immediate tax obligation that might have been avoided if the trustee had invested in securities that could have been distributed in kind. IRC §§1221-1222. With an awareness of that problem, the trustee must act in good faith when choosing to use a common fund and when resigning as trustee. See *Vale v Union Bank* (1979) 88 CA3d 330, 151 CR 784.

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§5.47 E. Real Estate

In the matter of real estate investments, the trustee has the usual fiduciary duty to use care, skill, and caution in analyzing both the role of real property in the trust's overall portfolio and strategy and the risk-reward trade-offs involved. See Restatement (Third) of Trusts §90 (2007). Real estate investments offer, among other advantages, a low correlation of returns with publicly traded equity and debt securities (increased diversification), long-term protection against inflation, and the opportunity to structure returns to the trust in the form of higher cash flow (for income) or appreciation. Against these advantages, however, the trustee must weigh the special problems and extra risks that often occur with real estate investments. There are often higher transaction costs, continuing management costs, and unanticipated risks that result from land-use patterns, economic trends, and regulation. In addition, real estate investments often involve special financing arrangements and tax considerations. The trustee should possess a thorough understanding of the responsibilities involved in managing real estate assets and should not hesitate to involve specialists if necessary.

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§5.48 1. Ongoing Management Duties

If the trust assets include real property, the trustee should obtain appraisals of the property at routine intervals. This allows the trustee to obtain adequate insurance protection and keep current on the relevant real estate market.

The trustee is responsible for maintaining sufficient casualty and liability insurance, using as a guide normal practice on similar buildings. See Restatement (Third) of Trusts §76, Comment d (2007); Restatement (Second) of Trusts §176, Comment b (1959). Insurance premiums are a proper expense of the trust. See Prob C §16240. *Woodard v Wright* (1889) 82 C 202, 22 P 1118. The trustee should also consider the need for flood or earthquake insurance. This decision depends on the location of the property, the types of structures, the ability of the trust estate to bear an uninsured loss, the cost of premiums, and the commercial availability of the desired coverage. If these problems are beyond the trustee's level of expertise, an insurance specialist should be consulted.

Improved real property requires ongoing maintenance and inspection. If the property has tenants, the trustee may engage on-site management or professional property managers to handle day-to-day management and maintenance. Property owners, particularly landlords, have a duty to inspect premises for defects and to correct any defects found. *Peterson v Superior Court* (1995) 10 C4th 1185, 43 CR2d 836.

The trustee should review any leases or rental agreements on property held in trust, particularly those leases about to expire. Trustees should also investigate relevant market rent levels before entering negotiations for a lease extension or for a new lease. A skilled real property broker or manager can be helpful in this area.

The trustee has statutory authority to enter into leases that may extend beyond the term of the trust. Prob C §16231.

The trustee has an obligation to collect rent and is liable for failing to do so without adequate reason. *Purdy v Johnson* (1917) 174 C 521, 163 P 893. If a tenant fails to pay, the trustee may need to file an unlawful detainer action to evict the tenant.

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2. Purchases and Sales of Real Property

§5.49 a. Power of Sale

The trustee has the power to sell trust assets unless expressly prohibited from so doing by the trust instrument. Prob C §16226. *Church v Church* (1940) 40 CA2d 696, 105 P2d 640.

Some trust instruments restrict the trustee's power to sell real property by imposing absolute prohibitions on sale, conditional restrictions, or requirements for beneficiary consent. A trustee who determines that the property should be sold despite such a restriction should petition for authority under Prob C §17200. If investment powers are shared or allocated to an advisor, the trustee must coordinate any sale with the cotrustee or advisor.

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§5.50 b. Trustee's Decision to Sell

The trustee must exercise care and prudence in deciding whether to sell trust property. Prob C §16047(a). A trustee's decision to sell real property, as with other trust assets, is measured by the prudent investor rule. Prob C §16047(c). The factors to consider include whether the property has become an inappropriate trust investment, tax considerations, including realization of capital gain or loss, costs of sale, and the interests and needs of the beneficiaries. See Prob C §16047(c); see §5.24.

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§5.51 (1) Valid Reasons for Sale

It is prudent to sell real property that has become an inappropriate trust investment in light of the trust objectives. For example, real property retained as a residence for a settlor or beneficiary may become an inappropriate investment if it ceases to be used as their residence. If the property needs substantial renovation, it may be best to sell it rather than deplete the trust to make it productive.

The trustee normally may not sell real property simply because it is inconvenient to manage, *e.g.,* if the trustee moves to Los Angeles and the property is located in Ukiah. However, a decision may properly take into account the cost of hiring a property manager. The trustee may base a sale on the need to diversify if the trust corpus consists of one large parcel.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.52 (2) Tax Considerations

§5.52 (2) Tax Considerations

Sales of real property present income tax issues similar to those that arise when any asset is sold. For example, the resulting realization of capital gain or loss must be compared with the anticipated benefit from the sale: Should the trustee sell a highly appreciated property that earns little income in order to exchange it for an asset that has a higher rate of return?

There are tax opportunities in real estate transactions. For example, the trustee may mitigate the capital gains impact of a sale of real property by using the tax-free exchange provisions of IRC §1031 if the trustee simultaneously acquires other qualified real estate. A trustee may also spread the tax impact of a sale over several years through an installment sale. See §5.61 for discussion of tax-deferred exchanges and §5.60 for discussion of installment sales.

The trustee should review all tax factors with the trustee's attorney and the trust's accountant before any sale is consummated. Because many tax factors have a direct and substantial impact on the beneficiaries, good practice dictates that, as early as possible, they should be informed of a decision to sell and its consequences.

If the trustee plans to reinvest sales proceeds in real estate, the trustee must consider, among other factors, the increased property tax liability of the new property. See Proposition 13 (Cal Const art XIIIA).

An individual is allowed a $250,000 ($500,000 for married couples filing a joint return) exclusion from tax of gain on the sale of a principal residence owned and used by the taxpayer for 2 of the 5 years preceding the sale, reduced by the amount of gain allocated to periods of nonqualified use. The exclusion may be applied to one sale or exchange every 2 years. IRC §121.

The exclusion also applies to:

- The estate of a decedent;
- Any individual who acquired the property of a decedent dying after this date as a result of the decedent's death; and
- A trust which, immediately before the death of the decedent, was a qualified revocable trust. IRC §121(d)(11). (A "qualified revocable trust" is one which remains revocable by the decedent until his or her death. IRC §645(b)(1).)

It should be noted that if one acquires the property from a QTIP trust or bypass trust created as a result of the decedent dying, the exclusion will not be available. A QTIP trust or bypass trust created as a result of a deceased settlor's (first spouse to die) death under a joint (qualified) revocable trust will not be the "same" trust as a qualified revocable trust referred to in IRC §121(d)(11)(C).

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.53 (3) Cost of Sale

§5.53 (3) Cost of Sale

In selling real estate, the trustee must consider numerous legal issues. For example, there may be a question whether under local ordinances the property can be sold "as is" or must be repaired or enhanced before sale. (On disclosure of faulty conditions to prospective buyers, see CC §1102.2(d), which exempts trustees from statutory real property disclosure requirements, except in the case of a natural person who is a sole trustee of a revocable trust and a former owner or an occupant in possession within the preceding year.) The cost of required repairs must be balanced against the net proceeds of the sale to determine whether the sale price is adequate. The trustee may decide that it is more advantageous to make minimum repairs and continue to receive rental income. See Prob C §16011.

Other costs of real estate sales include brokers' commissions, escrow and recording fees, transfer taxes, pest control, and other building inspection charges. Although the seller and buyer can negotiate who actually pays the costs, the ultimate sale price reflects the costs, thus affecting the amount actually received by the trust.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.54 (4) Sentiment of Beneficiaries

§5.54 (4) Sentiment of Beneficiaries

If the trustee is selling a family residence that has sentimental value for the beneficiaries, the trustee should tell the beneficiaries the reasons for sale before the sale is consummated. Failure to do so may generate unnecessary hostility between the trustee and beneficiaries.

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§5.55 c. Methods of Sale

There are several ways in which a trustee can place real property on the market. The method used will depend on the nature of the property and on the trustee's expertise. Corporate trustees will be more willing, and have in-house expertise, to market property directly. On the other hand, an individual trustee may have little experience buying or selling real property, or may have no license to market the property directly.

The goal of any method is to expose the property to as many potential buyers as possible and to obtain the best financial transaction for the benefit of the trust and the beneficiaries. Toward that goal, unless the individual trustee possesses the requisite skills or license to market the property personally, an exclusive listing with a real estate broker will usually be the best method. The trustee will want the property listed in a multiple-listing service and advertised in a professional manner through signs, newspapers and, where applicable, open houses in order to reach all potential buyers.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.56 (1) Exclusive Listings

§5.56 (1) Exclusive Listings

The individual trustee should usually enter into an exclusive listing agreement that gives the real estate broker an exclusive right to sell the property for a definite period. Court approval is not required to enter into an exclusive listing agreement. Prob C §16247. See CC §1086(f)(1) for statutory terms of such agreements. Customarily, exclusive listing agreements will set a price and terms, generally all cash, at which the trustee will sell the property. The trustee is obligated to sell the property only when the buyer matches the price and terms of the listing; otherwise, the trustee may refuse any offer. The trustee may also reject a counteroffer by a potential buyer who accepts the terms but adds other terms, *e.g.,* credits, deductions, clearances, and allocation of costs, that make the deal unsatisfactory.

The terms of the listing agreement should be carefully reviewed to determine whether the trustee is obligated to pay a commission if the buyer contacts the trustee directly. Listing agreements typically cover all aspects of the transaction, including the broker's rights, duties, and right to compensation. See California Real Property Sales Transactions §§2.62-2.88 (4th ed Cal CEB 2007). See CC §1086 for definitions of terms used in broker contracts.

Nearly all transactions involve listing brokers (who represent the owners) and selling brokers (who represent the buyers). In fact, in order to ensure impartial, competent representation, the trustee and buyer should, preferably, be represented by different brokers. Although a real estate broker may enter into a dual agency on written authorization by buyer and seller, one questions the wisdom of a trustee who agrees to allow one broker to represent two naturally adverse parties.

Although listing agreements expire, they usually provide that the real estate broker has the right to a commission if a potential buyer, to whom the broker showed the property or contacted during the listing period, buys the property during a specified period after the listing expires. If a listing expires and the trustee is seeking another broker, it would seem prudent for the trustee to request that the broker whose listing expired compile a list of those potential buyers he or she may have contacted and for whose transaction within the specified period the real estate broker will claim a commission.

The real estate commission is negotiable in an exclusive listing agreement; it is not set by statute. And, if the trustee knows certain potential buyers who are or who may be interested in buying the property, the trustee may except these buyers from the listing agreement or contract for a lower commission. In modern real estate transactions, real estate brokers perform many required services for sellers in addition to finding a buyer. Trying to negotiate and consummate a sale or purchase of real property by oneself without expertise can be a pathway with many associated problems, including litigation.

PRACTICE TIP 1: It is advantageous to use exclusive brokers when the property requires special attention due to its location or condition. An exclusive listing may be necessary if the property requires a specialist broker, *e.g.,* one who deals solely in agricultural or commercial properties. On the various types of listings, see Real Property Sales §§2.54-2.61.

PRACTICE TIP 2: If the trust property is a cooperative apartment, prospective buyers typically must receive the co-op board's approval before consummating the sale. A broker who deals frequently with the building in which the trust co-op is located may facilitate board approval and may have a list of prospective buyers.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.57 (2) Nonexclusive Listings

§5.57 (2) Nonexclusive Listings

A trustee may enter into a nonexclusive listing. See CC §1086(e)(3). This arrangement allows interested buyers to deal directly with the trustee, avoiding the payment of a broker's commission. Under this arrangement, however, brokers will not be motivated to advertise or necessarily list on the multiple-listing service without the assurance of a commission. Advertising—and even listing on the multiple-listing service—is an out-of-pocket expense to the real estate broker. A nonexclusive listing offers no incentive, therefore, to perform those acts that a trustee customarily expects of a real estate broker. Other brokers, however, may be motivated to show the property in the hope of capturing the entire sales commission.

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(3) Selling Without a Broker

§5.58 (a) Corporate Trustees

Under certain circumstances, corporate trustees may sell trust real property by direct mail offers or requests for bids to an extensive list of real estate brokers and other interested parties. If the property is sold in this way, without a listing agreement, there may be no broker's commission to pay. Further, the trustee is under no obligation to accept any offer and, if no acceptable offers are received, the property may then be placed with a broker. An individual cotrustee must consent to this procedure before it can be used, and review and approve the offering before it is mailed. Prob C §15620. The individual cotrustee can assist in the sale by adding names to the mailing list and by distributing copies of the offering to the other prospective buyers. See chap 3 for a discussion of cotrustees.

Offerings normally specify a time and place for the submission and opening of all bids on the property, either from individuals or from brokers acting on behalf of prospective buyers. All cotrustees should be present at that time to review the offers and to agree on which one, if any, is to be accepted. If an individual trustee cannot be present, the cotrustees should arrange to discuss the bids on the telephone to reach prompt agreement. Bids are often submitted shortly before the closing of the bidding period and have a limited period for acceptance. Delays arising from a trustee's unavailability may be detrimental to the trust. For discussion of delegation between cotrustees, see chap 3.

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§5.59 (b) Inexperienced Trustees

An inexperienced individual trustee who markets property without a broker faces a risk of liability for any loss of value to the beneficiaries. Prob C §16440. An unsophisticated trustee could substantially undervalue the real property and be liable for the difference between the fair market value at the time of the sale and the price obtained. Prob C §16440. Inexperienced trustees might also fail to give the property sufficient market exposure. Further, the individual trustee is likely to be highly inefficient in marketing the property, billing the trust for hours of unnecessary time. This could lead to objections by the beneficiaries.

Very few individual trustees are sophisticated enough in real estate transactions to engage in one without professional assistance. Generally, trustees are well advised to seek a broker or other real estate professional as well as consulting with the attorney.

There may be special circumstances, however, when a trustee will not need the services of a real estate broker. For instance, for cooperatives or even planned communities, the managing agent may have lists of potential buyers. In these cases, the purchase prices may be well established by past sales of similar units or lots.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.60 (4) Installment Sales

§5.60 (4) Installment Sales

Installment sales of real property, by spreading recognition of capital gain over more than 1 year and producing interest income, can be highly advantageous to the trust. However, such sales can be a burden for the trustee. By the nature of installment sales, the trust becomes a lender to the buyer of the property. As lender, the trustee must confirm the creditworthiness of the buyer. The credit check, including the submission of a financial statement and credit references, should be completed before the sales agreement is executed. The credit investigation should also include a demand for examination of the borrower's income tax returns for 2 or 3 years before the sale.

In addition, unless the particular sale of real property qualifies for an exception under California law, 3 percent of the gross sales price (or a lesser amount if so elected and certified by the seller, but in no event less than the recognized gain multiplied by the income tax rate) must be withheld for California income tax at close of escrow unless the buyer agrees to withhold as required by law as to each monthly installment paid. Rev & T C §18662. The choice of how to withhold resides with the buyer. The burdens of this law may make an installment sale unattractive to the trust or to a potential buyer.

NOTE: Trusts are no longer exempted from the withholding requirement. Certain sales may be exempt, including the sale of property used as the deceased settlor's personal residence, but the trustee must still complete Real Estate Withholding Certificate (FTB Form 593-C), and retain it for 5 years following the close of the transaction. The form must be furnished to the Franchise Tax Board on request. Sales that result in a loss or zero gain are also exempt, but the trustee must complete Real Estate Withholding—Computation of Estimated Gain or Loss (FTB Form 593-E), usually to be retained by the seller, also for 5 years. See 2008 California Forms 593-C, 593-E, and Instructions.

PRACTICE TIP: For a more detailed discussion of the tax-related problems of an installment sale, see California Real Property Sales Transactions §§15.75-15.79 (4th ed Cal CEB 2007).

The promissory note in the installment sale must be secured by a deed of trust on the property purchased. The trust may be offered a junior (second or third) deed of trust as part of the sales agreement. Junior deeds of trust are not as secure as a first trust deed and should be avoided unless there is no other way to consummate a sale. See *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644. The deed of trust should be recorded in the office of the county recorder. The trustee must develop an accounting system to record loan payments for the life of the loan.

PRACTICE TIP: The promissory note should contain an attorney fees clause, allocating to the buyer the costs incurred in keeping the note current or in foreclosing on the property. The note should also include a late-payment penalty provision and, because of the tax consequences of a lump-sum early repayment, the trustee should consider a prepayment penalty clause as well.

NOTE: The trustee may be personally liable for any loss incurred by the trust if the borrower defaults because the trustee was negligent in failing to demand or collect payments. Prob C §16440. If the trustee's mismanagement causes the trust to lose income generated by the loan, the trustee may also be personally liable for the legal costs of collection efforts or foreclosure. See CCP §1026.

The trustee must prepare for the administrative responsibility of recording payments throughout the life of the loan. The trustee must also consider the effect on the loan of the trust's terminating before the loan matures. Questions such as whether the note securing the loan will be split among multiple beneficiaries or whether there will be a need for liquidity at termination that the note will not supply may arise.

Because of the possibility of inflation, a lengthy fixed-interest loan may be disadvantageous for the trust. The trustee can negotiate a variable-interest loan, but these loans require more supervision and substantial recordkeeping. If a foreclosure is required, the income stream is terminated until the property is recovered. The trust will incur additional costs for reselling the property. Further, during a foreclosure, the buyer may ignore routine repairs and maintenance on the property so that the property, when returned to the trust, has decreased in value, and returning the property to

marketable condition will consume additional funds.

Generally, unless the buyer is particularly creditworthy and the installment terms are particularly favorable, all-cash sales are preferred. The risks, loss of income, and the problems of a defaulting buyer make an installment sale undesirable.

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§5.61 (5) Tax-Deferred Exchanges

Under certain circumstances, a parcel of real property may be exchanged for another without realizing gain or loss. IRC §1031. To qualify for a tax deferral, property must be held for productive use in a trade or business, or held for investment purposes, and it must be exchanged for property of a like kind. IRC §1031(a)(1). Exchange transactions can range from two-party exchanges to more elaborate ones involving many parties. A discussion of the requirements for a tax-deferred exchange and the documents necessary to implement an exchange is beyond the scope of this book. For a thorough treatment of the subject, see Real Property Exchanges (3d ed Cal CEB 2002).

The §1031 exchange defers payment of the income tax on the gain resulting from the sale. A disadvantage is that the trust's basis in the acquired property is continued from the exchanged property; there is no change in the depreciation schedule. Treas Reg §1.1031(d)-1.

The decision to effect a tax-deferred exchange depends on the financial circumstances of the trust. As with any significant trust transaction, the trustee should consider consulting individual beneficiaries about use of an exchange. If necessary and if the trustee deems an exchange beneficial, the trustee should consider seeking court instructions on the propriety of an exchange to avoid later challenges by the beneficiaries.

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§5.62 (6) Sale at Auction

No statute requires sales of real property held in trust to be confirmed by a court, and the trustee cannot use the overbid procedure available under Prob C §10311 for sales of real property by a decedent's estate. Nevertheless, a trustee may decide it is prudent to sell property at auction, particularly if a beneficiary wants to buy the property. If the property is sold at auction, the transaction is clearly at arm's length for fair market value, and no issue of partiality can be raised by other beneficiaries. See Prob C §16003.

It also may be possible for the trustee, acting on Prob C §17200 instructions, to conduct a "bid up" sale that approximates the procedure for probate real property sales under Prob C §10311. In *Estate of de la Montanya* (1948) 83 CA2d 322, 188 P2d 494, the trustee petitioned for instructions under former Prob C §1120 to confirm his actions in accepting a bid on real property. The trustee requested the court to determine whether the price received had been the best obtainable. In reviewing the sale, the court inquired whether there were any higher bids, and, on receiving one, instructed the trustee to accept it.

It is problematic whether a court today will embrace the procedure in *Estate of de la Montanya*. If this method is attempted, any sales contract should be expressly made subject to court approval, just as in a confirmation for sale procedure in a probate proceeding. The trustee can also hire a professional auctioneer to handle the transaction. See Prob C §16247. Typically, the auctioneer will arrange for advertisements and the location for the sale, and will conduct the actual sale, subject to any limitations the trustee believes necessary, *e.g.,* establishing a minimum bid. The auction contract should indemnify the trustee from liability for any negligence, default, or other action of the auctioneer. The wisdom of an auction versus a sale through a real estate broker should be reviewed carefully to determine whether it is advantageous.

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§5.63 F. Partnerships and Other Business Interests

A trustee may continue to operate a business if authorized by the trust instrument or by the court. Prob C §16222(b). Ordinarily, a trustee is given express authority in the trust instrument to manage a business. If not, the trustee should petition the court under Prob C §17200(b)(8) for this authority. In the interim, a trustee without express authority in the trust instrument may continue the operation for a reasonable time pending the court hearing or pending a sale. Prob C §16222(c).

NOTE: Under the provisions of Prob C §16222(b), the lease of four or fewer residential units is not considered to be the operation of a business.

A business is among the most difficult of trust assets. A trustee managing an ongoing business as a sole proprietor or a general partner may be personally liable for the business debts if, due to the trustee's breach of trust, the trust assets are insufficient to meet these obligations. See Prob C §16440. When the business interest is held as a corporation, the trustee must adhere to all corporate formalities to ensure that neither the trust nor the trustee will be liable. See chap 10. It is beyond the scope of this book to discuss management of businesses.

Other factors can make businesses improper trust investments. Certain businesses require that the owner be professionally licensed, *e.g.,* a medical practice, a law practice, or a construction company. Corporate trustees may lack the necessary personnel to manage a business. Individual trustees often are unfamiliar with business management. If the trustee lacks the skills or customer confidence of the settlor, the business will not likely be operated profitably. Even if they are familiar with a business and capable of managing it, individual trustees may not have the time or inclination to do so, and the cost of a salaried manager may exceed the net revenue of the business. Hiring an advisor to operate a business may be an improper delegation. The partners of a small business are likely to reject an outsider's intervention in the management of the business. Conflicts between the partners and the trustee on how to manage the business could lead to an inordinate waste of time and money.

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1. Partnerships

§5.64 a. General or Limited Partnerships

A trust may hold either general or limited partnership interests. The former may be a method of owning an ongoing business, limited by Prob C §16222. A general partnership will often be a business that the trust cannot conduct without specific authority. However, even when the trustee is authorized to participate in the business of the partnership, or the partnership is not a business (*e.g.,* it holds raw land for appreciation), the investment may not be prudent. Because the trust will have unlimited liability for the partnership's debts, the trustee should, in most cases, dispose of the general partnership expeditiously. On partnership liabilities, see Advising California Partnerships, chap 3 (3d ed Cal CEB 1999).

The trustee's attorney should advise the trustee of his or her potential personal liability for the partnership's debts. See Prob C §16401(b).

Because limited partners have limited liability and generally no control over management, investment in a limited partnership should not, for purposes of Prob C §16222, constitute the operation of a business any more than owning shares in a corporation. An argument can be made that investment in a limited partnership is a delegation of investment authority because the limited partner has no direct authority over the partnership management. The better view, however, is that the trustee's role, as with mutual funds, is to decide whether the initial investment in the limited partnership is prudent and to provide an ongoing review of its appropriateness for the account. One drawback of limited partnership investments is that they may be relatively illiquid.

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§5.65 b. Disposing of a Partnership Interest

Many general or limited partnership agreements provide for a buy-out of a deceased partner's interest by the surviving partners. Such agreements provide either for a specified sales price or a method of valuing the business to set a buy-out price. Frequently, the buy-out price is determined either by an agreed-upon appraiser or through arbitration. Absent a buy-out agreement, the remaining partners may want to purchase the trust's interest to eliminate potential conflicts with the trustee. Unless there is a prohibition on substitution of partners in the partnership agreement, the trustee may sell the trust's interest to a third party. In that case, evaluating the business and the terms of purchase requires skillful negotiation to ensure that the trustee gets the highest possible price and best terms. For further discussion, see Business Buy-Sell Agreements (Cal CEB 1991).

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2. Closely Held Corporations

§5.66 a. Corporate Characteristics

A family-held corporation is the type of business most commonly placed in trust. Unlike proprietorships and general partnerships, the closely held corporation limits the trust's liability to the amount of equity in the corporation. See 9 Witkin, Summary of California Law, *Corporations* §30 (10th ed 2005). Statutory law and case law limit the trustee's ability to hold the stock of a closely held corporation by normally requiring diversification of assets (see Prob C §16048) and the sale of nonproductive property. See Prob C §16007 (duty to make trust property productive). These limitations can be avoided by proper drafting of the trustee's powers and by giving the trustee the express authority to invest in or to continue to hold the stock. A trustee who holds a minority interest usually will not exert significant management control. The trustee, to vote proxies properly, still must be reasonably informed about company operations. See Prob C §16047(a).

Some closely held family corporations are S corporations. See IRC §§1361-1379. These are corporations whose shareholders have elected to have the entity taxed as a partnership. An S corporation pays no corporate taxes. The shareholders are taxed on the income and receive the corporation's deductions. IRC §§1363(a), 1366. A grantor trust may hold shares in an S corporation (IRC §1361(c)(2)(A)(i)), but the successor trustee must dispose of the interest within 2 years after the settlor's death unless the trust will meet the requirements for a qualified Subchapter S trust (QSST) (IRC §§1361(c)(2)(A)(ii), (d)). When the stock is part of a probate estate, the trustee has 2 years after the stock is distributed into the trust to dispose of it. IRC §1361(c)(2)(A)(iii).

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§5.67 b. Effect of Family Member Participation

Family members can be assets to a trust-held business. They can also be liabilities. Family members often are entrenched in a company and resent the shift in management power to a trustee. A family member's performance may not comport with his or her title, salary, or job responsibilities.

Family members are likely to be trust-income or remainder beneficiaries. If the family member is an income beneficiary, he or she may want the company to pay out maximum income. A remainder beneficiary may want profits to be diverted back into the business for future growth. The trustee should try to anticipate these and other family issues before they affect the operation of the trust-held business. The decision to retain or dispose of a family-held business may hinge upon the extent of such problems. The trustee must balance the competing interests of various classes of beneficiaries against the actual needs of the business. At the outset, the trustee must explain to beneficiaries that, while their points of view will be considered, the final decisions will be made by the trustee alone, seeking to serve the best interests of the trust.

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§5.68 3. Management Issues in Sole Proprietorships, Partnerships, and Closely Held Corporations

Frequently, a trustee will delegate the active management of a proprietorship, partnership, or closely held corporation to competent management and advisors. Prob C §16052(a). However, the trustee should periodically review the agent's overall performance and compliance with the terms of the delegation. Prob C §16052(a)(3). When the trust holds a minority interest in the business, the trustee should attempt to remain fully informed about the business operation and be as active as possible in its management. If the trust owns a majority share, however, the trustee must balance the duties of a trustee against the duties of a majority shareholder, *i.e.,* in relation to the minority shareholders. The duties of the majority shareholder are set forth in *Jones v H.F. Ahmanson & Co.* (1969) 1 C3d 93, 81 CR 592. *Jones,* a nontrust case, held that majority shareholders have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just, and equitable manner. They may not use their power to benefit themselves alone or in a manner detrimental to the minority. 1 C3d at 109, 81 CR at 600. But see *Sax v World Wide Press, Inc.* (9th Cir 1987) 809 F2d 610. The trustee's fiduciary obligations toward the minority shareholders may conflict with those toward the beneficiaries of the trust shareholders, creating competing fiduciary duties for the trustee. There is as yet no California case law that addresses this issue.

If the trust holds enough shares in a corporation to elect members to the board of directors, the trustee may have the opportunity to sit on the board. One view is that the decision not to do so is an improper delegation by the trustee. Another is that the trustee may vote for someone else to represent the trust's interest, since the trustee's obligation is to vote the stock in the best interests of the trust. 3 Scott & Ascher on Trusts §18.1.8.2 (5th ed 2007). There is no California statutory or case law giving guidance on this issue.

If the business has a competent manager when it becomes a trust asset, it may be best to retain that person in the position. If not, the trustee must carefully seek a competent, knowledgeable manager. Business brokers may be a good source of information about potential managers. Other sources include personnel agents, classified advertising, and business schools.

The trustee should retain a qualified accountant to audit the company's books annually and to handle the corporate tax work. The company will also require legal counsel. When the trust is not the sole owner, the trustee will not be able to employ the same attorney or firm that represents the company because of the potential conflict of interest. See Cal Rules of Prof Cond 3-310(D).

If a member of the State Bar of California has transferred the economic interest of his or her practice to a trustee and the member is deceased or disabled, a petition may be brought to appoint a practice administrator under Prob C §17200(b)(22)-(23).

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§5.69 4. Determining Whether to Continue or Dispose of the Business

A trustee who decides that an unincorporated business is not a proper trust investment must arrange for its orderly liquidation or sale. The first step in selling a business is to obtain an appraisal. Even if the trustee decides to retain the business, an analysis and valuation are needed to gauge the potential success of the business and the propriety of retaining the business as a trust asset.

If the trustee is expressly directed to operate the business, the trust instrument should include a hold-harmless provision insulating the trustee from personal liability. Absent such a provision, the trustee should petition for the addition of such language or, in the alternative, for permission to dispose of the business. Prob C §17200(b)(6), (b)(8). When the trust instrument permits but does not require retention, the trustee need not obtain court approval to sell the business.

In some cases, the trustee may choose to continue a business even without the authority of the trust instrument. For example, a prompt sale may be impossible to effect at a reasonable price; or, prior contractual obligations may hinder a sale; or, estate tax liability may make it advisable to postpone a sale. The trustee must petition the court for express authority to continue the business. Prob C §16222(b)-(c).

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.70 a. Analyzing the Business

§5.70 a. Analyzing the Business

An analysis of a business requires examining:

- The type of business and its history;
- Past operating results and financial condition;
- Present physical facilities and the need for capital improvements;
- The quality of the products and services;
- The competitive environment; and
- The economic environment.

If the trustee is unfamiliar with the business and the industry in general, a business analyst or appraiser should be retained. Independent firms and some financial institutions prepare such analyses.

Corporate trustees sometimes perform in-house evaluations of businesses held in trust. The institution's credit department may do the analysis if there is no lending relationship between the bank and the company. Office of the Comptroller of the Currency Fiduciary Precedents 9.3895. This analysis may differ markedly from the opinion of the business held by family members and employees of the business. The trustee or the trust's attorney may be called on to explain the trustee's analysis to interested parties.

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§5.71 b. Valuing the Business

The type of valuation required will depend on the type of business. For example, in a service business that has little or no salable goodwill, fixtures may be the only assets, and a personal property appraiser or even a used furniture dealer can put a market value on them. When the business assets consist of retail inventory, a wholesaler or manufacturer of similar products can estimate their value.

Valuation of a closely held corporation or other businesses that are more than a one-person service business may be much more complex. The Internal Revenue Service suggests various factors to use, including:

- The company's net worth;
- The company's prospective earning power;
- The company's dividend-paying capability;
- The company's goodwill; and
- The value of other companies in the same or similar type of business listed on a stock exchange.

For a complete list of the factors suggested by the IRS, see Treas Reg §20.2031-3; Rev Rul 59-60, 1959-1 Cum Bull 237. Although these factors are used by the IRS to value a business for death-tax purposes, they apply equally well for other purposes.

There is a considerable literature on valuation of businesses. For an overview, see Business Buy-Sell Agreements (Cal CEB 1991).

Regardless of the type of business being valued, or by what means, the trustee must look at the return to be made on the principal investment and calculate the risk in obtaining that return. If the risk does not appear immoderate for the expected return and the business otherwise appears to be an appropriate investment for the trust, the trustee may decide to retain it.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.72 c. Finding a Buyer

§5.72 c. Finding a Buyer

The following processes are useful in finding a buyer for a business:

- Contact owners of similar businesses through trade associations or directly; approach franchise firms that operate the same type of business; and
- List the business for sale in trade publications and mass media classified advertisements.

A trustee who is familiar with the business may be able to sell it without resorting to a broker. A trustee who is not should retain a business opportunities broker. This is particularly true if the sale is of a closely held corporation, because the stock must be properly transferred or the corporation dissolved. There are myriad details in wrapping up the affairs of a corporation, including compliance with the Uniform Commercial Code—Bulk Sales (Com C §§6101-6111) and notification of the various local, state, and federal taxing and regulatory agencies and the firm's creditors. These considerations are beyond the scope of this book.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.73 d. Assessing the Tax Impact

§5.73 d. Assessing the Tax Impact

Before negotiating a sale of a business, the trustee must determine the tax impact, both on the trust and on the individual beneficiaries, of various types of sales. An outright sale of the stock of a private company may incur substantial capital gains, which can be avoided or mitigated if the sale is in exchange for the stock of another company or is made on an installment basis. This area of the law is immensely complex, however, and competent legal and tax advice should be sought.

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§5.74 e. Considering the Impact on the Family

Family members may have a strong emotional attachment to a long-held family business, particularly if the business carries the family name. Family members may object to a sale, despite objective reasons for it, and resent the decision to sell of a relatively unknown trustee. There are no easy solutions, but the trustee's attorney can reduce the friction by explaining the rationale for the sale to the family before the event occurs. The attorney's support for the trustee's decision may carry great weight and make it easier for family members to accept.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.75 G. Tangible Personal Property

§5.75 G. Tangible Personal Property

Tangible personal property (*e.g.,* jewelry, precious gems, fine art) has traditionally been deemed unsuitable for trusts because it is non-income-producing, not liquid, and speculative. Under Prob C §16047, however, the propriety of holding such assets depends on the needs of the trust as a whole, its beneficiaries, and any directions of the settlor. A settlor may have placed all of his or her assets into the trust, including tangible personal property, to avoid probate.

The trustee's standard of care, skill, and diligence for holding tangible personal property is the same as for any other trust property. See Prob C §16047. Such property should be appropriately insured against loss.

PRACTICE TIP: If the settlor is alive and possesses tangible personal trust property, the trustee should be protected against harm to the property by a provision in the trust instrument relieving the trustee of all responsibility for its safekeeping, maintenance, repair, or insurance. While it remains in the settlor's possession, the trustee should be responsible for only that tangible personal property that actually comes into the trustee's possession by physical delivery by the settlor or an authorized agent of the settlor.

Whether or not the property is in the trustee's possession, the trustee should see that the assets are properly insured under a policy in the trustee's name that clearly describes the assets. The trustee should consider photographing the property as an aid to identification. In addition, the trustee should inspect the property to ensure its continued existence, location, and good physical condition, making written notes of those inspections.

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§5.76 1. Storage

Tangible personal property in the trustee's possession should be properly stored. See Prob C §16047; 3 Scott & Ascher on Trusts §17.8 (5th ed 2007). The appropriate type of storage depends on the asset: furniture may be stored in a warehouse; paintings and stamps require specialized storage to prevent deterioration; jewelry, coins, and other small valuables should be stored in a safe deposit box in the trustee's name. The storage facility should be inspected from time to time to ensure that it is secure and meets the trustee's storage requirements.

The trustee must decide whether items stored in a safe deposit box need to be insured. Although the risks of theft or destruction of the premises housing the box are small, the trustee may not wish to assume even these risks. There is no California authority on whether failure to insure assets placed in a safe deposit box is deemed imprudent. The trustee should balance the risk against the cost of insurance. Items stored in a safe deposit box should be routinely appraised to establish value for insurance or for loss purposes. A trustee who removes uninsured items from the box should obtain an insurance binder to protect against loss until the property is back in the box. This is typically done when valuable jewelry is worn only occasionally by a beneficiary.

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§5.77 2. Appraisal and Insurance

The trustee should obtain an appraisal of any tangible personal property at *replacement value,* which is the amount currently required to repurchase like property. Absent contrary language in the instrument, such appraisals are ordinary expenses that are proper charges against income. Prob C §16370(c). The appraisal may be used as a basis for obtaining insurance on the articles.

The trustee should not rely on tangible personal property values listed on the Inventory and Appraisal form filed in the probate estate, but should obtain a new appraisal instead. The estate valuation is supposed to be fair market value, but because this value is the basis for estate taxes, the valuation may be at the lower end of the range of reasonable valuations.

Insuring specialized items, *e.g.,* stamps, coins, and art, may pose difficulties. An insurer may require special appraisals and certifications on the procedures used to protect the property. The insurer may also require that burglar alarms, smoke detectors, fire alarms, or other security devices be installed before writing the policy.

The trustee must adjust the policy limits on personal property as its value changes. Normally, insurance companies require proof of value at regular intervals, *e.g.,* every 3 to 5 years. With particularly valuable items, the trustee may wish to reappraise more often to be sure the coverage is sufficient for the market value.

The trustee should insure trust property even if the property is in storage or on consignment for sale. Stored property can be stolen or damaged. Many storage companies offer casualty insurance for the property they hold. However, policies issued by consignment or storage companies should be examined carefully to be sure they are comprehensive and meet the needs of the trust. If certain risks are not insured under the policies, *e.g.,* earthquakes or floods, the trustee should consider obtaining supplemental coverage if the risk exceeds the premiums that would be charged. If the trustee opts for independent insurance coverage, special reporting requirements may apply. For example, trustees are commonly required to promptly notify the insurer of any relocation of the property.

When the property is held on consignment, the trustee's attorney should review the consignment contract to make sure the consignee is required to provide adequate insurance until the property is sold. The property should also be insured during any time in transit.

The cost of insurance on tangible property is charged against trust income, even though the assets are not income-producing. Prob C §16370(d).

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.78 3. Proof of Ownership

§5.78 3. Proof of Ownership

When insuring or selling tangible personal trust property, the trustee may have to prove ownership. When the asset was received into a testamentary trust, the decree of distribution may describe the asset in sufficient detail to serve as proof. The trustee may also request the settlor of a living trust or the personal representative of an estate to execute a bill of sale that will serve as proof of ownership.

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4. Sales of Personal Property

§5.79 a. Reasons for Sale

If the trust instrument directs that tangible personal property, *e.g.,* furniture, jewelry, and stamp or coin collections, be retained for future distribution to specified persons, the property must be retained and stored. Prob C §16000. See §5.76.

Absent a direction to retain or distribute the property, the trustee should dispose of it promptly unless its retention is part of an overall investment strategy. Prob C §16220. It does not produce income and storage and insurance will be costly for the trust corpus.

Sometimes trust beneficiaries will want to purchase the personal property out of family sentiment. The property must be valued before it is sold. If the property is of nominal value, the trustee may sell it at fair market value to any beneficiary who wants it. If the property has substantial value, or if several beneficiaries want the same item, the trustee should have them bid on the property against other interested third parties. That way, the trust receives the best price and the trustee will avoid any charge of favoritism. Prob C §16003. Alternatively, if the trustee has obtained a formal fair market appraisal of the trust property, and the beneficiary is willing to pay the appraised value, the trustee can petition the court for instructions. Prob C §17200(b)(6).

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.80 b. Methods of Sale

§5.80 b. Methods of Sale

Different skills and techniques are required for selling different types of tangible personal property. The sale of jewelry requires knowledge different from that required for the sale of a stamp collection. A trustee who is knowledgeable in the particular area may handle the sale personally; otherwise the trustee should retain an expert to ensure that the property is handled correctly and to realize maximum return from the sale.

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(1) Furniture

§5.81 (a) Household Furnishings

Sale of household furnishings can be time consuming. The trustee may request a fee for the time involved in the sale, but it may be disproportionate to the financial results of the sale and difficult to defend. In most cases, furniture is best marketed by a dealer or auctioneer. See §5.83. If the sale is conducted on the premises of the testator or settlor, the trustee should check that such activity is covered by the homeowner's or renter's liability and casualty policy.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.82 (b) Antique Furniture

§5.82 (b) Antique Furniture

Trust estates frequently include either several fine antiques or an entire collection of antique furniture. The best price for such items is usually obtained by placing them on consignment with an auction house. See §5.83. If there are only a few items, and the trustee is knowledgeable about antiques, he or she can handle the sale personally. This may consume a substantial amount of time and the trustee's fees for this time might be viewed skeptically by beneficiaries.

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§5.83 (c) Sale by Auction House

Particularly valuable furniture may best be sold through an auction house to obtain the widest exposure and the best price possible. Auction houses routinely handle trustee sales. On auction contracts, see §5.84. Normally, the auction house will take a percentage of the sales price for each item as a commission. The auctioneer will also expect to be reimbursed for moving expenses. In return, the auction house will arrange for advertising, display the property, and pay any sales or other taxes due.

The auctioneer advertises the sale widely to the public and interested collectors. The trustee can set minimum bids (a reserve price) to prevent property from being sold below market value.

The trustee should determine the sales dates in advance if he or she knows of anyone interested in bidding on any of the items. A sale deadline keeps the auctioneer from procrastinating. If the property is stored for prolonged periods, there is a greater chance of loss or damage.

It is good practice for the trustee to inspect the auction arrangements to be certain the trust property is displayed to advantage. If dissatisfied, the trustee should promptly demand the desired changes. Most contracts specify that the auction house agrees to use its best efforts to obtain maximum prices and otherwise to conduct the auction in a businesslike manner.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.84 (d) Auction Contract

§5.84 (d) Auction Contract

Many auction houses have their own form of contract. The fiduciary's ability to modify the auction house's form is limited.

The trustee may set a reserve price—a minimum bid beneath which the auctioneer may not sell the item—on items of particular value. Even if the trustee does not set a reserve on items, he or she can negotiate with the auctioneer to get at least the appraised value of the property. Such an agreement should be in writing.

The auction house's commission is usually negotiable, even to an amount less than the standard contract figure.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.85 (2) Jewelry and Gems

§5.85 (2) Jewelry and Gems

Jewelry may be sold to dealers who specialize in estate purchases. Such dealers or jewelers are best used when the jewelry is of modest value. The trustee should request bids from at least two such jewelers, if possible, to be certain of obtaining the best price.

If the trust holds fine jewelry or valuable unset gems, a major auction house will normally achieve the best result for the trust. The trustee might contact prominent jewelry firms if the jewelry or gems are particularly valuable or unique.

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§5.86 (3) Stamps and Coins

Stamps and coins are specialized assets that normally require a knowledgeable dealer to market well. Trustees who are not personally knowledgeable should employ a reputable dealer.

A stamp dealer affiliated with the American Philatelic Society can advise the trustee of sales procedures appropriate to the value of a stamp collection. For coins, dealers affiliated with the American Numismatic Association will provide advice for United States coins; dealers belonging to the American Numismatic Society will be able to provide information on foreign or other coins. Such dealers can also appraise the collection. While affiliation with a trade association will not guarantee a dealer's integrity, these associations typically police their membership to maintain standards of performance.

If a trustee cannot locate one of these member dealers locally, or wishes to obtain more information about a particular dealer, the trustee should contact the associations at their national headquarters.

American Philatelic Society
100 Match Factory Place
Bellefonte, PA 16823
(814) 933-3803
http://www.stamps.org

American Numismatic Association
818 N. Cascade Ave.
Colorado Springs, CO 80903
(800) 367-9723
http://www.money.org

American Numismatic Society
75 Varick Street, 11th Floor
New York, NY 10013
(212) 571-4470
http://www.numismatics.org

For substantial or specialized collections, there are national and international firms known for their expertise. In determining what is substantial, the trustee may use an objective standard, *e.g.,* specific value, or take the opinion of a qualified dealer. Certain specialized collections, *e.g.,* pre-1900 United States stamps, or ancient Medean or Persian coins, can best be sold by or to a dealer who handles that particular subspecialty. If local dealers cannot provide the names of such firms, the public library carries the stamp and coin trade periodicals in which these firms advertise.

The trustee should write to the selected dealers, describing the collection in detail. A representative of the firm will likely respond by making a personal inspection, or provide detailed instructions on how to ship the collection safely for inspection. Although these major firms will purchase items outright, the trustee should seriously consider placing the items on consignment or at auction to obtain the best possible price.

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§5.87 (4) Works of Art

If the settlor or testator gives specific and detailed instructions about the disposition of valuable works of art, the trustee must follow them. Prob C §16000. Without such instructions, the trustee should determine whether the settlor or testator worked with a dealer who knows this collection. Such a dealer might accept a consignment sale agreement. There are many subspecialties in the art world, and the trustee should deal with the appropriate specialist to ensure proper marketing of the work. Apart from a consignment sale, depending on the specific art involved and the current state of the art market, many items can also be sold through the auction houses.

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§5.88 (5) Other Collectibles

Virtually any type of collection has value to other collectors. Publications specializing in almost every type of collectible can be obtained from the library. Even if the trustee is totally unfamiliar with the collection involved, appraisals and purchase offers from specialized dealers will usually be sufficient to allow the trustee to ascertain the market price.

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.89 H. Loans and Collateral

§5.89 H. Loans and Collateral

A loan of trust funds at interest is a valid trust investment. As with any investment, a loan must be appropriate for the overall circumstances of the trust. Prob C §16047. Before lending money, the trustee must evaluate the terms of the loan, including interest rate, repayment schedule, collateral or security, and prepayment penalties. The trustee must make sure that the security is adequate protection for the trust and that the loan is not simply an accommodation to a beneficiary but rather a secure, prudent long-term investment.

The trustee should survey institutional lenders to determine the current market rates and terms. The trustee may want to consider a variable interest rate if the loan is for an extended term.

The trustee must investigate the borrower's financial condition and obtain adequate security for the loan. *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644; *Estate of Hamon* (1922) 60 CA 154, 212 P 399. If there is no security and the beneficiary defaults, the trustee may be surcharged because an unsecured loan would not be considered a prudent investment. See Prob C §16047. If the trust lends funds to remainder beneficiaries, the same problems exist, compounded by the fact that trust income (except, perhaps, discretionary payments) is unavailable for repayment.

The trustee's attorney should advise the trustee on legal requirements for the taking of security and should prepare the documents. Although it may be prudent to take a first deed of trust on real property as collateral, taking a second deed is frequently imprudent because of the risk that the first deed may be foreclosed. If the value of the property substantially exceeds the amount of both encumbrances and the trust has sufficient resources to cure a default on the first deed, there may be no problem. As to national bank trustees, see Office of the Comptroller of the Currency Fiduciary Precedents 9.4000 and 9.4005. Usually, second deeds of trust should be used only when settling a claim or selling a piece of property when it is prudent to do so under all the circumstances. *Estate of Collins, supra*. For all deeds of trust, the trustee must evaluate the property carefully to make sure the security is adequate, taking into account possible depreciation. *Estate of Collins, supra*.

PRACTICE TIP: If the trust has sufficient resources and taking a second deed would not be imprudent under the circumstances, the trustee should record a document called "Request of Copy of Notice of Default," which requires a senior encumbrancer to send notice of a recorded default.

The trustee must collect payments on notes held in trust and promptly take action to collect amounts in default so that rights are not lost by the running of the statute of limitations. CCP §337. However, the trustee is not a guarantor and need take only such steps as would a reasonable creditor. Prob C §16047. See *Estate of Gilliland* (1977) 73 CA3d 515, 140 CR 795.

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§5.90 1. Loans to Beneficiary or Trustee

A loan of trust funds to a beneficiary is allowed under Prob C §16244. However, lending money to a beneficiary should be considered carefully, as it may defeat the purpose for which the trust was created, *i.e.,* to protect the beneficiary from his or her own improvidence. If the trust contains a spendthrift provision, the beneficiary cannot assign future income from the trust for repayment without violating that clause. See chap 10.

Lending money to one beneficiary and not another could give rise to charges of partiality, although this is less of an issue when a sole income beneficiary is the borrower. Prob C §16003. See chap 2 on the duty of impartiality. To preempt such charges, the trustee may consider petitioning the court for approval to make the loan when there are multiple similarly situated beneficiaries. Prob C §17200. The petition should provide detailed reasons for the loan, the provisions for repayment, the security for the loan, and any other pertinent facts.

Depending on its terms, a personal loan might not be considered a prudent investment under Prob C §16047. Problems of monitoring the loan security may arise and create a conflict with the beneficiary. If the beneficiary defaults, other beneficiaries could initiate a breach of trust action against the trustee. However, a responsible beneficiary may request a reasonable loan for a valid purpose, and the trustee may grant the request under Prob C §16244.

Lending money may actually further the purposes of a trust, as when the settlor's child or grandchild needs funds for the downpayment on his or her first house and can adequately secure the loan with a deed of trust on the house. The loan is particularly safe if the beneficiary will receive distribution of some or all of the principal within the next few years.

Although there may be valid reasons for the trust to lend money to beneficiaries, there is never a valid reason for the trustee to borrow funds from the trust, on any terms. Such a transaction is self-dealing by the trustee and an improper utilization of his or her authority. Prob C §16004(a); see chap 2.

NOTE: Under certain conditions, a trustee may lend his or her own funds to the trust, but normally this should not be done. When the trustee lends money to the trust, the trustee may be seen by the beneficiaries as being more concerned with having the loan repaid than protecting their interests. If the loan goes into default because the trust does not have enough liquid assets to continue payment, the trustee will be caught between the duty to protect the trust's assets and a desire to have the loan paid off.

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§5.91 2. Term Insurance if Loan Unsecured or Inadequately Insured

A beneficiary who seeks a loan of trust funds but has no collateral can purchase a term insurance policy in the amount of the loan, naming the trust as the beneficiary in the event of death. When the trust terminates, the trust beneficiary can either cancel the policy or designate another beneficiary.

The trustee should be certain that the borrower cannot change the beneficiary designation on the policy without the trustee's consent. Because the beneficiary designation arrangements are part of the security for a loan, the borrower has not made a gift of the insurance, so there are no gift tax consequences. Of course, the trustee also needs assurance that the borrowing beneficiary will pay the insurance premiums. The trustee may require the insurance company to use the trustee's address for premium notices, thus ensuring the trustee's control over premium payments. The security instrument will permit the trustee to make payments, and the failure to pay will constitute a default. Alternatively, the beneficiary may direct or request the trustee to pay premiums from any income to which the beneficiary is entitled. Note, however, the potential problems of spendthrift provisions. See chap 10.

Term insurance protects the trust only if the beneficiary dies before the loan is repaid. It will not protect the trust from a borrowing beneficiary who simply defaults on a loan. If the trustee is concerned about possible defaults and the security is not adequate, the loan simply should not be made.

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§5.92 3. Loan Terms

In addition to considerations of security for the loan, the following issues should be addressed:

- *Termination Date*. When there is no specific termination date in the trust instrument, the trustee's problems in determining adequate security for a loan are compounded. Term insurance that declines in value over time can be useful and appropriate if its rate of decline matches the payoff on the loan. Otherwise, it will be necessary to obtain a policy with a level face amount, even though the premium rises.
- *Interest on the Loan*. The interest rate charged should be close enough to the market rate to avoid the provisions of IRC §7872. In some cases, for example when there is a single beneficiary and the interest is fully deductible, the interest charged and the resulting income would be a wash. If there are or might be other income beneficiaries, however, and to avoid §7872 problems, the trustee is better advised to charge market-rate interest.
- *Periodic Payments and Termination Date*. The trustee should establish a schedule of periodic payments and a termination date for the loan. If a trust distribution to the borrowers is likely during the term of the loan, the trustee and borrower should consider whether part or all of that distribution will consist of a partial or total cancellation of the loan.

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§5.93 I. Oil, Gas, Water, and Mineral Interests

Oil, gas, water, and mineral interests can be held in a limited partnership, a royalty trust, or outright. If the interest is located out of state, the trustee's (especially the corporate trustee's) ability to take title will depend on whether the interest is considered personal or real property.

Distributions of royalties to the trustee are generally made by the entity managing the trust or partnership or by the mining or drilling operator directly. The trustee must review royalty statements for accuracy. If the interest produces substantial income, the trustee should consider hiring an advisor to review accountings.

In allocating receipts from these natural resources between income and principal, the trustee should review Prob C §16363 and know the source of the payment. In general, §16363 allocates 90 percent of payments to principal and 10 percent to income. Even though §16363 allocates 90 percent to principal, the trustee should also determine whether a depletion reserve is appropriate. See §8.26.

Special rules apply to receipts from the sale of timber and related products. Prob C §16364. See §8.27.

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§5.94 J. Liquidating Assets: Patents, Trademarks, Copyrights, and Royalties

The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) includes patents, trademarks, copyrights, and royalty rights within the definition of "liquidating assets." Probate Code §16362 defines a "liquidating asset" as a "right to receive payments under an arrangement that does not provide for payment of interest on the principal balance." Probate Code §16362 requires trustees to allocate 10 percent of receipts to income and 90 percent to principal.

Documents evidencing assets in the form of patents, trademarks, copyrights, and royalty rights usually are placed in a trust by the settlor. The trustee must review such documents to confirm that payments made are correct. The trustee should calendar renewal dates, if any. Changes in the law in 1976 eliminated copyright renewals for new works. See 17 USC §302. Changes in the law in 1998 extended copyright durations. Works copyrighted before January 1, 1978, and then still in their first term had a copyright period of 28 years from the date of the copyright, with a 67-year renewal. 17 USC §304(a). Works in their renewal term on January 1, 1978, were extended to expire 95 years from the original copyright date. See 17 USC §304(b). Works copyrighted after January 1, 1978, are protected for the author's life plus 70 years. 17 USC §302. The trustee's attorney should consult a specialist in these areas or refer the trustee to a specialist if he or she is not skilled in the area. See Cal Rules of Prof Cond 3-110(C).

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Source: Estate Planning/California Trust Administration/5 Investments and Management of Assets/§5.95 K. Borrowing for Trust Purpose

§5.95 K. Borrowing for Trust Purpose

If the trust develops a cash-flow problem or has a need for funds beyond the cash available, the trustee may consider borrowing money. National bank trustees are prohibited from borrowing for investment except to improve real estate, unless there is borrowing authority in the trust instrument or in local law. OCC Fiduciary Precedents 9.4065. Probate Code §16241 permits trustees to borrow for any trust purpose, and Prob C §16226 permits acquisition of property on credit. The power to borrow, however, like all other powers, is subject to the trustee's fiduciary duties. See Prob C §16202. The trustee also cannot borrow for the benefit of a third party or a beneficiary, rather than for a trust purpose, unless the trust instrument so provides.

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§5.96 1. Deciding Whether to Sell or Borrow

The trustee must first decide whether it is better to borrow funds or sell trust assets. The following are some of the factors that bear on those issues:

- *Duration of Need*. When the need is short term, *e.g.,* renewal of an existing loan, it may be appropriate to borrow. If the trust itself is expected to last a long time and the funds are needed to improve a substantial asset that has potential for either appreciation or increased income flow, it may also be appropriate to borrow.
- *Effect on All Beneficiaries*. Interest on the loan is chargeable to trust income. Prob C §16370(c). Thus, the trustee must balance the interest costs against the needs of the income beneficiaries. See §5.9. If the borrowing increases cash flow, the income beneficiaries' interests are protected.
- *Ability To Repay Loan*. The trust estate must be able to repay the loan while meeting the needs of the beneficiaries. If trust income is insufficient to meet trust obligations, however, borrowing is obviously not wise.
- *Tax Effects*. Sale or exchange of assets may create tax obligations, which in turn reduce the trust fund by the amount of the tax. Borrowing money has no immediate tax effect, but reduces future income by the interest paid during the term of the loan. The tax consequences on sale or exchange may be minimized by use of the installment method of reporting gain. See California Real Property Sales Transactions §§9.14-9.21, 9.24-9.39 (4th ed Cal CEB 2007).

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§5.97 2. Factors in Borrowing

The trustee must act prudently in borrowing funds for the trust. Prob C §16047. See §5.2 (investment standard of care). The trustee should compare the loan terms of several lenders to determine which lender offers the most advantageous terms for the trust. Factors to consider are:

- Term of loan;
- Ability to renew or assume, and to prepay without penalty;
- Collateral required;
- Rate—if variable, whether there is any cap, the frequency of adjustments, and the basis for adjusting; and
- The amount of points or loan fees.

As with any contract, the trustee should execute all documents "as trustee" to protect against personal liability. See chap 10.

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6

Environmental Issues in Trust Administration

Alexandra Laboutin Bannon

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I. LIABILITY OF TRUSTEES AND TRUST ASSETS FOR CLEANUP OF TRUST PROPERTY CONTAMINATED WITH HAZARDOUS WASTE

§6.1 A. Summary of State and Federal Environmental Statutes

Various federal, state, and local environmental laws and regulations have become applicable to trustees since 1980, creating responsibilities for the trustee—and potential liabilities for both the trustee and the assets held in trust.

Federal environmental laws applicable to trustees and trusts include:

- The Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675), which imposes liability for investigation and cleanup of hazardous waste sites.
- The Resource Conservation and Recovery Act of 1976 (42 USC §§6901-6992k), which controls the handling, storage, and disposal of solid waste and hazardous substances and regulates underground storage tanks (42 USC §§6991-6991i).
- The Clean Air Act (42 USC §§7401-7671q), which controls all emissions into the air, including radon and asbestos.
- The Federal Water Pollution Act (commonly called the Clean Water Act) (33 USC §§1251-1387), which regulates release of pollutants into surface and underground water.
- The Toxic Substances Control Act (TSCA) (15 USC §§2601-2692), which allows the EPA to identify and regulate substances likely to pose health hazards to persons or the environment.

California environmental statutes applicable to trustees and trusts generally track the federal laws. For example:

- The Carpenter-Presley-Tanner Hazardous Substance Account Act (HSAA) (Health & S C §§25300-25395.32) covers investigation of, and liability for, cleanup of hazardous waste. Its provisions are interpreted according to federal case law under CERCLA, with some limited exceptions, which are discussed below.
- The Hazardous Waste Control Law (Health & S C §§25100-25250.28) regulates generators of hazardous waste.
- Health and Safety Code §§25280-25299.8 regulate underground storage tanks in coordination with federal regulations.
- The Porter-Cologne Water Quality Act (Wat C §§13000-14958) grants the State Water Resources Control Board the authority to issue and enforce water quality control standards.

Municipal ordinances generally control permits for, and the use and removal of, underground storage tanks and regulate local businesses that use hazardous substances. Thus, the trustee must identify, understand, and comply with three different legislative and regulatory schemes when handling environmentally sensitive trust property.

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§6.2 B. Liability Scheme for Cleanup of Hazardous Waste Under Environmental Law

The trustee's responsibilities and liabilities under federal, state, and local environmental law arise from the public policy behind such law, which assigns responsibility for cleanup of contaminated property on the basis of status, rather than fault. The most familiar liability scheme is that created by CERCLA, on which most state and local laws are fashioned. Some of the basic concepts of CERCLA, including the definition of a potentially responsible party (PRP), retroactivity, strict liability, and joint and several liability, are discussed in §§6.3-6.5.

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§6.3 1. Potentially Responsible Party

A "potentially responsible party" (PRP) under CERCLA is a "person" who falls within one of the following categories:

- A current "owner" or "operator" of contaminated real property or a polluting business (a "vessel or facility");
- A former "owner" or "operator" during whose tenure an unauthorized disposal or release of a hazardous substance occurred at the facility;
- A "generator" of hazardous waste or an "arranger" for the disposal of hazardous waste; and
- A "transporter" of hazardous waste. See 42 USC §9607(a); Health & S C §25323.5(a).

Under CERCLA, a "person" includes an individual, corporation, partnership, and various commercial and governmental entities, but not a trust. See 42 USC §9601(21). However, a trust is a "person" under federal and state laws regulating underground storage tanks. 42 USC §6903(15); Health & S C §25281(k).

An "owner" under CERCLA is generally the person who holds legal title to contaminated property. *New York v Shore Realty Corp*. (2d Cir 1985) 759 F2d 1032, 1043. An "operator" is generally any person who has the authority to control the process that causes contamination at the time that hazardous substances are released. *Kaiser Aluminum & Chem. Corp. v Catellus Dev. Corp.* (9th Cir 1992) 976 F2d 1338, 1341. In most cases, the operator manages the facility or supervises or actively participates in the activities that generate, release, or dispose of hazardous waste. The operator may be a corporate officer, an employee, or an active shareholder. A "generator" arranges for the disposal of hazardous substances. See *U.S. v Northeastern Pharm. & Chem. Co*. (8th Cir 1986) 810 F2d 726; 42 USC §6903(6).

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§6.4 2. Retroactivity

CERCLA applies retroactively. *Nevada ex rel Dep't of Transp. v U.S.* (D Nev 1996) 925 F Supp 691. It covers contamination resulting from hazardous waste disposal many years before the passage of environmental legislation. 42 USC §9607(a)(2); *U.S. v Northeastern Pharm. & Chem. Co*. (8th Cir 1986) 810 F2d 726, 732. Contamination from activities that were legal before CERCLA may cause a fiduciary to become embroiled in expensive litigation as a potentially responsible party (PRP). For example, in *Castlerock Estates, Inc. v Estate of Markham* (ND Cal 1994) 871 F Supp 360, Bank A had served, 20 years earlier, as conservator and executor for an estate holding a community property interest in a ranch on which legal cattle dipping took place at the time. Bank B, which subsequently acquired Bank A, was brought in as a PRP and defendant in a lawsuit for damages resulting from the contamination caused by that cattle dipping. Similarly, in *Lone Star Indus., Inc. v Horman Family Trust* (10th Cir 1992) 960 F2d 917, the trustee became a PRP for hazardous waste disposal that had occurred during the lifetime of the deceased settlors.

The California environmental liability and cleanup law, the Carpenter-Presley-Tanner Hazardous Substance Account Act (HSAA) (Health & S C §§25300-25395.32), appears by its language to apply only to contamination occurring after January 1, 1982. However, no case has interpreted this statute.

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§6.5 3. Strict Liability; Joint and Several Liability

Identification of appropriate potentially responsible parties (PRPs) is not always easy. Frequently, contaminated property has passed through the hands of many owners, tenants, or business operators over the years. Each such PRP-defendant could point to the others to avoid liability for hazardous waste contamination. To spare enforcement agencies and plaintiffs the onerous burden of pinpointing the specific moment at which contamination occurred, CERCLA and other statutes apply strict liability to PRPs for cleanup costs (also called remediation, response, or removal costs), without requiring proof of culpability or causation.

CERCLA does not state how liability is to be applied among jointly liable PRPs, but provides for contribution among PRPs if the harm is found by the court to be divisible. See 42 USC §9613(f). Traditionally, courts apply joint and several liability to CERCLA cases, believing that it ensures the availability of sufficient funds for cleanup of hazardous waste sites. See *U.S. v Monsanto Co*. (4th Cir 1988) 858 F2d 160; *New York v Shore Realty Corp.* (2d Cir 1985) 759 F2d 1032. Joint and several liability under CERCLA can be asserted even if the PRPs are government agencies. *U.S. v Hunter* (CD Cal 1999) 70 F Supp 2d 1100. One PRP can be required to pay all cleanup costs in full and bring suit against others for contribution under a private cause of action created by CERCLA. Several courts, however, have refused to apply joint and several liability if the PRP can prove a reasonable basis for apportioning liability among various defendants. See, *e.g., In re Bell Petroleum Serv., Inc*. (5th Cir 1993) 3 F3d 889. See also *Burlington N. & Santa Fe Ry. v U.S.* (2009) 556 US ___, 173 L Ed 2d 812, 129 S Ct 1870.

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C. Potential Liability of Trustees for Environmental Costs Under Trust Fund Theory

§6.6 1. Development of Trust Fund Theory in Case Law

If the deceased testator or settlor was personally liable under CERCLA for cleanup of contaminated property, this liability may follow all the property of that PRP's estate or trust into the hands of a testamentary trustee or a successor trustee, even if the contaminated property is not an asset of the trust. Under the "trust fund" theory developed by courts, the testamentary trustee or successor trustee holds the assets received from the decedent's estate or living trust in constructive trust to satisfy the decedent's environmental liabilities. In *State ex rel Howes v W.R. Peele, Sr. Trust* (ED NC 1995) 876 F Supp 733, the court applied the trust fund theory, holding the surviving spouse/testamentary trustee liable, both personally and as a fiduciary, for environmental claims against the decedent. In *Steego Corp. v Ravenal* (D Mass 1993) 830 F Supp 42, the court permitted an action directly against individual beneficiaries of an estate to meet the estate's environmental liability. In neither case had the decedent's personal liability been determined by a court during his lifetime.

Other courts have rejected the applicability of the trust fund theory to estates and trusts. See *Witco Corp. v Beekhuis* (3d Cir 1994) 38 F3d 682 (failure to file timely creditor's claim in probate estate precludes application of trust fund theory to beneficiaries under will); *Norfolk S. Ry. Co. v Shulimson Bros. Co.* (WD NC 1998) 1 F Supp 2d 553 (beneficiaries of a fully distributed and closed estate are not subject to CERCLA liability under trust fund theory).

A trustee must be aware of the trust fund theory of liability, because this theory makes the testamentary or successor trustee liable for cleanup costs in an amount not to exceed the fair market value of assets originally received by that trustee from the estate or the settlor, including the value of any assets that had belonged to the decedent and were later distributed from the trust by the trustee to the beneficiaries. Thus, the trustee may become liable for the dollar amount of principal distributions made from the trust before the determination of liability, as well as for assets on hand in the trust at that time.

NOTE: It remains unclear how the statutory fiduciary exemption under CERCLA and California law affects the trust fund theory. See §§6.8-6.10 for a discussion of the fiduciary exemption. Although it appears that courts will continue to reject the application of the trust fund theory of liability to testamentary and successor trustees, the Ninth Circuit has not yet ruled on this issue. Therefore, practitioners advising a proposed trustee should remember the continuing potential for liability of trust assets, and possibly the trustee, under this theory.

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§6.7 2. Possible Strategies for Proposed Trustee

The proposed trustee may inquire of the family whether the decedent had owned property that was later, in the hands of a new owner, discovered to be contaminated. If the answer is affirmative, the proposed trustee might consider the following steps:

- Create a reserve of trust assets for potential liability under a trust fund theory;
- Obtain indemnification by beneficiaries for the amount of trust distributions to them; or
- Obtain a court order on final distribution of the trust that any environmental liability of the trustee under the trust fund theory will become the liability of the beneficiaries receiving the assets from the trust.

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II. LIMITATIONS ON LIABILITY

A. Exemption of Innocent Trustees From Personal Liability Under Environmental Statutes

§6.8 1. Federal Statutes

Under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675) and the Resource Conservation and Recovery Act of 1976 (RCRA) (42 USC §§6901-6992k), a trustee's liability for a release or threatened release of a hazardous substance on trust property may not exceed the value of the trust estate. 42 USC §9607(n)(1).

The federal exemption does not apply if

- The trustee's negligence caused or contributed to the contamination;
- The trustee is liable independently of ownership or actions taken in a fiduciary capacity;
- The trustee acts in a capacity "other than that of a fiduciary or in a beneficiary capacity" and in that capacity directly or indirectly benefits from a trust or fiduciary relationship; or
- The trustee is also a beneficiary of the trust and receives benefits that exceed customary or reasonable compensation and incidental benefits permitted under applicable state law. 42 USC §§9607(n)(2)-(3), (7).

The fiduciary exemption provisions of CERCLA and RCRA list those actions of a trustee which will not result in personal liability. These include:

- Undertaking a cleanup;
- Responding to an agency enforcement order;
- Terminating the fiduciary relationship;
- Incorporating special environmental provisions (including indemnification of the trustee) into the trust instrument or enforcing such provisions;
- Inspecting trust property;
- Modifying the trust;
- Administering trust property that was contaminated before the fiduciary relationship began;
- Providing financial or other advice to the settlor or beneficiaries; or
- Declining to take any such action. 42 USC §9607(n)(4).

The federal exemption from personal liability for trustees applies to any claim that had not been finally adjudicated as of September 30, 1996. Pub L 104-208, §2505, 110 Stat 3009-469.

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§6.9 2. California Statutes

California statutory law contains provisions remarkably similar to the federal exemption. For example, a trustee's liability for cleanup costs, damages, penalty, fine, imposition, or assessment arising from a release or threatened release of a hazardous material or substance is limited to, and may be satisfied only from, the assets of the trust estate. Health & S C §25548.3(a). This exemption does not protect a trustee from liability if the trustee is guilty of a tort or breach of contract with reference to the contamination. Health & S C §25548.3(a). The trustee must comply with environmental operational requirements, such as permitting, reporting, monitoring, emission limitation, financial responsibility and assurance requirements, and compliance with agency orders for removal or remedial actions. Health & S C §25548.4(d). However, the trustee is not required to inspect property of the trust to qualify for the exemption. Health & S C §25548.4(m).

The California statutory exemption does not apply if (Health & S C §25548.5):

- The trustee's negligent or intentional or reckless conduct causes or contributes to the release or threatened release of a hazardous material or substance;
- Contamination occurs as a result of a cleanup by the trustee without notification to the appropriate agency;
- Contamination results from activity by the trustee in a capacity other than as trustee;
- The fiduciary relationship was structured for the purpose of evading liability under environmental law; or
- The trustee is also a beneficiary of the trust or the trustee receives benefits that exceed the customary or reasonable compensation for administration of the property permitted under state law.

NOTE: The exemption of trustees from personal liability under state environmental law does not affect their liability for breach of trust under the California Probate Code. Health & S C §25548.4(e).

The California statutory fiduciary exemption applies to actions filed or orders issued after December 31, 1996. Health & S C §25548(c). The statutory exemptions in the California Health and Safety Code and CERCLA overrule lower court cases that have held fiduciaries personally liable under certain circumstances. See *Castlerock Estates, Inc. v Estate of Markham* (ND Cal 1994) 871 F Supp 360 (conservator personally liable as owner of contaminated property if conservator had power to control use of property without court approval); *City of Phoenix v Garbage Servs. Co.* (D Ariz 1993) 816 F Supp 564, modified at 827 F Supp 600 (bank that held landfill as testamentary trustee is personally liable as owner of property).

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§6.10 3. Case Law: Scope of Fiduciary Exemption

The scope of the fiduciary exemption under CERCLA was considered by a federal court in *Canadyne-Georgia Corp. v Nationsbank* (11th Cir 1999) 183 F3d 1269. In *Canadyne,* a Georgia limited partnership, WCW, operated a pesticide manufacturing factory on partnership land that became contaminated as a result. In 1942, a majority of WCW limited partnership interests were transferred to an irrevocable trust, the trustee of which was a predecessor of Nationsbank. The WCW general partnership interest was later distributed to the trust from the settlor's estate. In 1977, WCW was acquired in its entirety by Canadyne, which sold the pesticide business but retained the contaminated land. After receiving an EPA order to clean up the site, Canadyne brought suit against Nationsbank for contributing to the contamination as a former owner of the property.

Applying Georgia statutory law of the 1970s, under which general partners were deemed to hold legal title to all partnership property, the court held that Nationsbank was an owner of the contaminated site under CERCLA during the time that the trustee was general partner of WCW. The court concluded, however, that the bank's liability under CERCLA was limited to the assets held in a fiduciary capacity under the fiduciary exemption. Because Nationsbank had not been sued in its fiduciary capacity, the court did not discuss how the value of fiduciary assets was to be determined when the trust had been distributed.

The court agreed that the trustee could be personally liable if its negligence had caused or contributed to the contamination. However, the court did not consider failure to stop someone else from releasing hazardous substances to be negligence by the bank, because CERCLA does not create a duty to prevent contamination. The court did not consider whether such a duty arose under fiduciary law because the bank was not sued in its fiduciary capacity.

NOTE: As the first appellate decision to apply the fiduciary exemption under CERCLA, the *Canadyne* case is particularly important because it emphasizes the narrow scope of the exceptions to the fiduciary exemption from liability under CERCLA. The court specifically quotes the statutory language that no new liability or cause of action against a fiduciary is created by the fiduciary exemption to CERCLA; the exemption limits only liability that might otherwise be present.

NOTE: Before the *Canadyne* decision, a federal district court in Georgia had held that a trustee's failure to recognize and require correction of environmental problems on trust property leased to a third party could constitute negligence, making the trustee personally liable under CERCLA's fiduciary exemption. *Briggs & Stratton Corp. v Concrete Sales & Serv.* (MD Ga 1998) 20 F Supp 2d 1356. The Eleventh Circuit Court of Appeals apparently rejected this position in the *Canadyne* decision, although the *Briggs & Stratton* case was not specifically mentioned by the court. However, the practitioner advising a fiduciary cannot assume that the Eleventh Circuit's position on this issue will be adopted in California.

NOTE: For a confusing interpretation of the fiduciary exemption which seems to expand the trustee's liability, see *U.S. v Newmont USA, Ltd.* (ED Wash 2007) 504 F Supp 2d 1050, holding that, although the liability of a fiduciary is limited to the value of trust assets, the fiduciary exemption statute does not require that the potential liability be paid from trust assets. The trustee could be required to pay environmental costs from assets outside the trust. No other court has spoken on this particular issue.

The *Canadyne* case is also important because the court applied state law to determine whether the trustee was an owner under CERCLA. By extension, state law should also be applied to determine what constitutes negligence under the fiduciary exemption. See *U.S. v Bestfoods* (1998) 524 US 51, 141 L Ed 2d 43, 118 S Ct 1876 (state law must be applied to determine whether corporate veil can be pierced under CERCLA).

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§6.11 B. The "Heir or Beneficiary" Defense Under CERCLA

The "heir or beneficiary" defense in CERCLA protects an owner of contaminated property from any liability under CERCLA if all the following criteria are met (see 42 USC §9601(35)(A)(iii)):

- The owner acquired the contaminated property as an heir through intestate succession or as a beneficiary under a will;
- The property was acquired after disposal or release of hazardous waste on the property; and
- The heir or beneficiary did not contribute to the contamination.

The "heir or beneficiary" defense has severe limitations, and in fact offers little protection to trusts and trustees for the following reasons:

- It applies only to a trustee appointed under a decedent's will, but does not protect the trustee of a private living trust (or the executor of a decedent's estate).
- The trustee has the burden of proving, by a preponderance of the evidence, that the trustee did not contribute in any way to the contamination on the property. 42 USC §§9601(35)(A), 9607(b)(3).
- CERCLA legislative history indicates that the "heir or beneficiary" defense is available only if the heir or beneficiary made "due inquiry" into the condition of the inherited property. See dictum in *U.S. v Pacific Hide & Fur Depot, Inc*. (D Id 1989) 716 F Supp 1341 (those who acquire property through inheritance or bequest without actual knowledge of contamination may rely on "heir or beneficiary" defense if they engage in reasonable inquiry). No case or statute has defined the "reasonable inquiry" to be made by an heir or beneficiary. However, the EPA has issued regulations, effective November 1, 2006, outlining stringent standards for "all appropriate inquiries" under CERCLA for "innocent landowners." 40 CFR pt 312. See detailed discussion at §6.15. If these standards were applied to heirs or beneficiaries, this defense would become even more limited in its scope.

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C. Use of Creditors' Claims Statutes and No-Claim Statutes to Protect Trustee

§6.12 1. Case Law Interpretation of Relevant Statutes

Recent case law suggests that if a deceased settlor was a potentially responsible party (PRP), the settlor's trust may be protected from liability under CERCLA by (1) the plaintiff's failure in an environmental lawsuit to file a timely creditor's claim under Prob C §§9100 and 19100 or (2) the 1-year statute of limitations on survival of claims contained in CCP §366.2.

The Ninth Circuit has not addressed the application of these statutes to environmental claims against trusts or estates of deceased PRPs. In *Witco Corp. v Beekhuis* (3d Cir 1994) 38 F3d 682, however, the Third Circuit ruled that a plaintiff's action under CERCLA against a personal representative was cut off by the plaintiff's failure to file a timely claim under the Delaware creditors' claims statute, although the action was properly filed within the statute of limitations for CERCLA. The court rejected the plaintiff's argument that CERCLA preempted state statutes that govern administration of decedent's estates.

Under the *Witco* decision, Probate Code §§9100 and 19100 and the 1-year limitations period of CCP §366.2 would apply to actions based exclusively on the liability of a deceased testator or settlor filed by third party PRPs against trustees. For example, if the settlor owned or operated contaminated property, but sold it before death, the shortened limitations period might apply. If the trustee owns or operates the contaminated site, however, the trustee and the trust estate have independent liability, which cannot be limited by CCP §366.2 or by the creditors' claims statutes.

Although courts and commentators generally consider the *Witco* holding to be the better position, some courts have held that CERCLA preempts state creditors' claims or no-claim statutes. See *Steego Corp. v Ravenal* (D Mass 1993) 830 F Supp 42 (CERCLA preempts the Rhode Island Probate Code no-claim statute) and *Soo Line R.R. Co. v B.J. Carney & Co.* (D Minn 1992) 797 F Supp 1472 (personal representative and beneficiaries liable under CERCLA although no creditor's claim filed). Trustees should also be aware that liability to federal agencies, such as the Environmental Protection Agency, cannot be cut off by the California creditors' claims statute. See *U.S. v Vibradamp Corp.* (SD Cal 1966) 257 F Supp 931.

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§6.13 2. Strategy for the Trustee

The *Witco* case provides several opportunities for the trustee and the settlor's family to develop a defense strategy against potential environmental liability when the trust estate does not contain contaminated property but the decedent may be liable under environmental law as a prior owner or operator. For example, the trustee could discuss with counsel and the family whether the settlor's will should be filed for probate. If a probate is opened, the personal representative of the settlor's estate can give notice to creditors through the probate administration without disclosing the existence of the settlor's trust. In most cases, potential plaintiffs, ignoring the settlor's trust, will identify the personal representative as the PRP-defendant for any action filed under CERCLA.

During the period of estate administration, the surviving spouse may decide to withdraw one-half of the community property in the trust, decreasing the amount of assets available to satisfy any environmental claim against the estate. Under CERCLA and California environmental law, the liability of an innocent trustee is limited to the value of assets held in trust. 42 USC §9607(n)(1); Health & S C §25548.3(a). See discussion of fiduciary exemption at §§6.8-6.10. The trustee has no duty, and in fact no ability, to prevent the surviving settlor from withdrawing that settlor's assets from the trust. Thus, the trustee's ability to invoke the protection of the exemption should not be harmed by the surviving spouse's actions.

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§6.14 D. Limiting Liability When Trust Property Will Be Leased to Third Parties

Under CERCLA and other environmental statutes, the trustee and trust may be held liable for cleanup of contamination on property leased to third parties. The trustee should consider protecting the trust by having environmental counsel draft (or review) leases on environmentally sensitive property, especially service stations. Leases may include protective clauses, including the following:

- Lessee will comply with all environmental laws and regulations;
- Lessee will regularly provide evidence of compliance with relevant environmental statutes, regulations, and permitting requirements;
- Failure to provide evidence of compliance will constitute a default under the lease;
- Failure to provide evidence of compliance will authorize the trustee to reenter the property and ensure compliance at the cost of the lessee;
- Lessee will indemnify the trustee and trust for any damages, environmental testing and cleanup costs, and attorney fees or other expenses resulting from contamination of leased property or other environmental law violations; and
- Lessee will provide environmental insurance, if available.

The trustee should also consider having the lessee take ownership by bill of sale of underground storage tanks, waste oil tanks, or other such improvements on the leased property that are within the lessee's control and are subject to environmental regulation.

The amount of control that the trustee is to have over the lessee's handling of hazardous waste must be very carefully drafted in the lease; a trustee who has too much control of the lessee's activities may become liable for contamination as an "owner or operator" of the business under CERCLA. 42 USC §9601(20)(A). See *Long Beach Unified Sch. Dist. v Dorothy B. Godwin Cal. Living Trust* (9th Cir 1994) 32 F3d 1364 (easement holder who had not actively controlled management of land not liable for cleanup costs after trust seller of property and former lessee settled with purchaser).

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III. THE ENVIRONMENTAL AUDIT, INVESTIGATION, AND CLEANUP

§6.15 A. The "Innocent Landowner" Defense Under CERCLA

Trustees should screen proposed trust property and tenant businesses for potential environmental problems, and attempt to avoid them. Environmental screening serves two purposes:

(1) The trustee can avoid taking title to property that is likely to be contaminated; and

(2) The trustee and the trust may rely on the "innocent landowner" defense (see 42 USC §§9601(35)(A), 9607(b)(3)), if contaminated property is accepted into trust after an appropriate environmental review.

When a trustee unknowingly buys contaminated property, the innocent landowner defense is useful for protecting trust assets from liability under CERCLA. The innocent landowner defense is available to the trustee who (1) acquired property after it became contaminated, (2) did not know, and had no reason to know, that the property was contaminated, and (3) did not contribute to the contamination. See 42 USC §§9601(35)(A), 9607(b)(3).

To qualify the trust for the innocent landowner defense, the trustee must undertake "all appropriate inquiries" into the environmental status of the property before the purchase. The investigation of property is frequently referred to as an "environmental audit." Minimum standards for the "all appropriate inquiries" test are set forth in 40 CFR pt 312, effective November 1, 2006, which outlines the various inspections and database searches required to be performed by the innocent landowner and the landowner's environmental consultant. The EPA regulations, effective November 1, 2006, specifically reference the ASTM Standard E1527-05 (Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process), discussed in §§6.16, 6.19, as complying with the required activities. 40 CFR §312.11.

Most investigations and inspections under the EPA regulations must be completed within 1 year before acquisition of the property, but visual inspections, interviews with property owners or operators, and database searches must take place 180 days or less before taking title. 40 CFR §312.20(a)-(b). The investigation must be conducted by an "environmental professional" who satisfies certain educational and experience standards. 40 CFR §312.10(b). Finally, the trustee also must (1) take into account the trustee's "specialized knowledge" of the property and its neighborhood, and (2) evaluate whether the purchase price is reasonable. 40 CFR §§312.28-312.29. "Specialized knowledge" is not defined. It is also unclear whether corporate fiduciaries will be required to collect specialized knowledge from other divisions or affiliates.

The "all appropriate inquiries" test should not apply to acquisition of contaminated property by a trustee into trust from a settlor or decedent. Under the California and CERCLA fiduciary exemptions (see §§6.8-6.9), a trustee who acquires contaminated property into trust is not required to inspect the property before acceptance. Health & S C §25548.4(m); 42 USC §9607(n)(4). The trustee who administers contaminated property has no personal liability for cleanup costs, unless the trustee's negligence contributed to the contamination. 42 USC §9607(n). Case law suggests that the trustee's negligence must be active; mere failure to inspect the property properly will not suffice. *Canadyne-Georgia Corp. v Nationsbank* (11th Cir 1999) 183 F3d 1269. However, trust assets will be liable for cleanup costs, unless the innocent landowner defense applies.

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§6.16 B. Initiating an Environmental Audit: The Threshold Review

Each environmental audit is different, based on the history and circumstances of the property in question. However, the initial step of an environmental audit is generally a threshold review, sometimes referred to as the "transaction screen process," to identify property with potential environmental problems. See §6.18. If proposed or existing trust real property has been identified in the threshold review as potentially contaminated, the trustee or proposed trustee often conducts what is commonly referred to as a Phase I investigation to discover the likelihood of a release or threatened release of hazardous substances on the property. See §6.19. If the Phase I investigation shows that contamination of the property is likely, the trustee or proposed trustee may wish to perform a so-called Phase II site assessment, which includes soil and water testing. See §6.20. If the Phase II investigation shows contamination on the site, a cleanup plan must be developed and carried out by the potentially responsible party (PRP) under the supervision of the governmental agency with jurisdiction over the site. See §6.21.

The EPA has developed specific standards for conducting "all appropriate inquiries" for an extensive environmental audit to establish liability protection, effective November 1, 2006. 40 CFR pt 312. See §6.15. In addition, the American Society for Testing and Materials (ASTM) International has developed the following voluntary standards for environmental audits:

- Standard E1528-06: Standard Practice for Limited Environmental Due Diligence: Transaction Screen Process (ASTM 2006) outlines an initial, noninvasive review of commercial real property, which can be carried out by a property owner or other nonprofessional. This constitutes limited environmental due diligence, *i.e.*, less than a Phase I Environmental Site Assessment.
- Standard E1527-05: Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process (ASTM 2005) intends to provide guidance on what constitutes "all appropriate inquires into the previous ownership and uses of the property consistent with good commercial or customary practice" as defined at 42 USC §9601(35)(B). This standard is specifically referred to in 40 CFR §312.11 as being sufficient to comply with the requirements set forth in 40 CFR §§312.23-312.31 relating to the innocent landowner defense (*e.g.*, interviews with past and present owners, reviews of historical sources of information, visual inspections). See §6.19.
- Standard E1903-97 (2002): Standard Guide for Environmental Site Assessments: Phase II Environmental Site Assessment Process (ASTM 2002) details the requirements for an invasive Phase II investigation of land. See §6.20.

All ASTM International Standards can be purchased online at http://www.astm.org. For a general discussion of environmental due diligence, see Forte, *Environmental Due Diligence: A Guide to Liability Risk Management in Commercial Real Estate Transactions*, 42 Real Prop, Prob & Trust J 443 (Fall 2007).

PRACTICE TIP: It is not clear whether general trust law gives a proposed trustee the right to inspect trust property at the trust's expense before accepting an appointment as trustee, or whether an acting trustee has the right to inspect and reject environmentally suspect property as an expense of trust administration. Thus, many trustees are now requesting attorneys to include these powers in the trust document.

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Source: Estate Planning/California Trust Administration/6 Environmental Issues in Trust Administration/§6.17 1. Relevant Information

§6.17 1. Relevant Information

Information and records that are relevant in conducting a threshold evaluation of real property include the following:

- The current or proposed use of the property;
- Family information on prior uses of the property;
- Records of the settlor or family attorney regarding prior transactions relating to the property;
- Location and surroundings of the property;
- Uses and condition of neighboring property; and
- A physical review of the property for signs of potential contamination or improper handling of hazardous substances, including unusual soil coloration, areas bald of vegetation, unusual odor or texture of the soil, odors, abandoned chemical containers, or 55-gallon tanks, vents, or fill pipes for underground storage tanks, or evidence of soil compacting or backfill of pits.

PRACTICE TIP: Regarding businesses already owned by the trust, the trustee should also request a review of their records, and those of any partnership or corporation controlled by the trust. These records should confirm that all necessary environmental permits have been obtained and reports have been filed. If a trust-owned business lacks an environmental permit or has failed to make a required report, the trustee may be exposed to severe civil and criminal penalties, including large fines and imprisonment. For example, §312 of the Emergency Planning and Community Right-to-Know Act of 1986 (EPCRA) (42 USC §11022) and its California equivalent, the Business and Area Plans Law (Health & S C §§25500-25520) impose civil and criminal fines, and even imprisonment of not more than 24 months, against business owners, including trustees, who use or transport hazardous substances and fail to meet certain recordkeeping and reporting requirements. 42 USC §11045; Health & S C §25515. The review of trust, partnership, and corporate records provides a safeguard for the careful trustee.

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Source: Estate Planning/California Trust Administration/6 Environmental Issues in Trust Administration/§6.18 2. Types of Real Property Uses and Businesses With Potential for Environmental Liability

§6.18 2. Types of Real Property Uses and Businesses With Potential for Environmental Liability

Particular uses of real property and certain businesses have greater potential for environmental liability for the trust and the trustee. Environmental problems, *e.g.,* may arise in connection with any property or business that:

- Uses, stores, or disposes of petroleum products, chemicals, or paints;
- Produces any product or byproduct that is toxic, corrosive, or otherwise harmful to human health or the environment; or
- Is required to obtain permits for storage, use, or disposal of any substance.

Businesses with potential environmental problems include (but are not limited to) gasoline stations, auto body or servicing, any business with an underground storage tank (see §§6.23-6.24), any business with a waste oil pit, chemical manufacturing plants, petroleum refineries, electroplating businesses, machine shops, dry cleaning stores, print shops, photo shops, paint or ink manufacturing companies, businesses that use paint or chrome, furniture manufacturing, gasoline storage, beauty salons, and auto rental or sales.

Frequently, agricultural land may contain underground storage tanks or may be contaminated with pesticides. Vacant land or a small business on a busy corner may be located on the former site of a service station with abandoned underground storage tanks or petroleum-contaminated soil or groundwater. Property located near environmentally suspect businesses may have become contaminated from dumping or groundwater flow from neighbors.

Asbestos was used in most buildings constructed before 1976. Any construction on an asbestos-containing building requires special permits and use of a special contractor.

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§6.19 C. Phase I Investigation of Potential Trust Property

If the threshold review discloses that proposed or existing trust real property is potentially contaminated with hazardous waste, the trustee or proposed trustee will often have environmental consultants conduct a Phase I investigation of the property. The goal is to discover the likelihood of a release or threatened release of hazardous substances on the property.

Phase I generally consists of a review of the following documentation:

- The recorded chain of title documents regarding the property for a period of 40 or 50 years;
- Government permits and other records showing use of the property for the same period;
- Recorded environmental cleanup liens;
- Government records showing contamination or potential contamination on neighboring sites; and
- Aerial photographs obtainable through government agencies.

During Phase I, the environmental consultant also visually inspects the property, all facilities and improvements on the property, and other properties adjacent to the inspected facility. The consultant looks for evidence of any chemical use or disposal on the property and reviews the storage, treatment, and disposal of hazardous substances on it.

After completing the documentation review and physical inspection, the environmental consultant should issue a written report that complies with the ASTM standard for a Phase I environmental site assessment that is recognized by governmental agencies and the environmental consultants as the industry norm. See Standard E1527-05: Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process (ASTM 2005), discussed in §6.16.

Because a Phase I report that fails to meet the ASTM standard does not qualify as due diligence under CERCLA, the trustee may refuse to accept any report that does not include a statement of compliance.

A complete Phase I investigation performed by an environmental consultant may cost up to several thousand dollars.

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§6.20 D. Phase II Investigation of Potential Trust Property

If the Phase I investigation reveals physical or historical evidence that the property is probably contaminated, the trustee or proposed trustee may wish to perform a "Phase II site characterization or site assessment investigation." In the Phase II investigation, geologists and other environmental consultants obtain and analyze samples of soil or groundwater, or both, in order to identify and quantify the nature and extent of the property's contamination by hazardous substances, and then prepare a written report that reflects the findings and conclusions of the investigation. The Phase II investigation and report may cost many thousands of dollars and take several months to complete.

If the Phase II sampling shows no sign of contamination, the environmental audit is complete. If, however, the sampling shows contamination, further investigation will be required to determine the type and extent of hazardous substances found in the soil or groundwater. Once the relevant environmental agency is confident that the parameters of the contamination have been identified, the potentially responsible party (PRP) will be requested to prepare a proposed cleanup plan for monitoring or remediation of the property. The PRP may begin the cleanup only after the supervising agency has approved the plan. Obtaining approval may take several years, because agency personnel are frequently overworked. See §6.21.

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Source: Estate Planning/California Trust Administration/6 Environmental Issues in Trust Administration/§6.21 E. Cleanup of Contaminated Property: Site Remediation

§6.21 E. Cleanup of Contaminated Property: Site Remediation

Once hazardous substances are discovered on trust property, the trustee's actions are subject to complex regulations that are beyond the scope of this chapter. However, the trustee should immediately contact environmental counsel to assist in reporting a release of hazardous substances, responding to governmental citations, or taking other environmental actions, because failure to report or respond may be a criminal offense. See Health & S C §§25189.5, 25190, and discussion below.

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§6.22 F. Selection of Environmental Consulting Firm

The trustee must depend on the expertise of an environmental consultant to perform Phase I and Phase II investigations and the cleanup of contaminated property. Careful selection of the environmental consulting firm is very important. The EPA has identified specific education, training, and experience requirements for a competent "environmental professional" to be qualified to conduct the requisite inquiry that is part of the "all appropriate inquiries" test. 40 CFR §§312.10(b)(2), 312.20(a)(2). See §6.15. Any consultant who meets these qualifications must certify so on all environmental reports. The trustee should check qualifications and obtain written confirmation that each consultant qualifies as such an "environmental professional." Because environmental consulting is a competitive business, the trustee also should obtain several written bids, detailing the work to be done and the cost. Certifications and licenses that are appropriate for environmental audit work may not be sufficient under federal or state regulations for cleanup of a contaminated site. For example, a "registered environmental assessor," approved by the California Department of Toxic Substances Control for Phase I reports, is not a licensed professional authorized by the State Water Resources Control Board to design and implement corrective action under the Underground Storage Tank Cleanup Fund. See §6.24. The trustee needs to confirm in writing that the selected professional has the appropriate registration or licensure for the work to be done.

When retaining a firm, the trustee should consider taking the following steps:

- Identify the specialization of the consulting firm. For example, a firm that specializes in the removal of underground storage tanks may not provide an adequate report on asbestos in a building.
- Select a consultant who performs some services directly rather than subcontracting all services to third parties. Note, however, that chemical analysis of samples is usually subcontracted to a diagnostic laboratory.
- Require that the consultant use EPA-approved methods of analysis of contaminated soil or water.
- Request that the consultant discuss the results of the Phase II sampling orally and provide a draft Phase II report before the final report is completed. Occasionally, consultants will include information in the report that is detrimental to the interests of the property owner and may be designed to ensure further employment of the consultant. Receipt of a draft report can eliminate an unpleasant surprise in the final report. The consultant should be directed to destroy all drafts, once the final report is completed.
- Request a complete report of findings ("site characterization or site assessment report") on completion of the Phase II investigation. Generally, the consultant's report will show the location and depth below ground of each soil and groundwater sample taken, the methods of analysis, and the type and quantity of hazardous substance identified in each sample, as compared with EPA minimum acceptable levels, background levels, and state or local no-action levels. Note that the consultant may be required to report certain contamination to environmental agencies.
- Require that the environmental consultant have adequate errors-and-omissions and general liability insurance.
- Review the consultant's standard contract to ascertain whether it limits the consultant's liability to the dollar amount of the contract, or requires the property owner to indemnify the consultant for all activity, including the consultant's own negligence. Such one-sided provisions should be deleted from the agreement before execution.

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IV. UNDERGROUND STORAGE TANKS: A COMMON ENVIRONMENTAL PROBLEM

§6.23 A. The Problem

One substantial area of concern for trustees or proposed trustees is underground storage tanks. Most single-walled underground storage tanks installed before the 1980s had an average useful life of 10 to 20 years before they might leak. Removal of a tank before 1984 did not require soil testing or cleanup. See Health & S C §§25298-25299; see also 42 USC §§6991-6991h. The trust or trustee may be liable for cleanup of property containing abandoned underground storage tanks from gas stations, farms, and even residences.

Gasoline contamination is under the jurisdiction of the State Water Resources Control Board, rather than the Environmental Protection Agency (EPA). Cleanup of gasoline contamination is a long and expensive process, because current remediation techniques are frequently incapable of attaining arbitrary standards required by state or federal regulations. The State Water Resources Control Board generally applies a more flexible, risk-based approach to assessment and cleanup of sites contaminated by gasoline and petroleum products. The Board may ameliorate enforcement of strict cleanup standards on property if "low risk" contamination of soil or groundwater does not endanger public health or the drinking water supply. The trustee who holds property with gasoline or petroleum contamination should review the status of the property with the environmental consultant and environmental counsel to determine whether an application for administrative closure can be made under the risk-based standard. If cleanup of gasoline leakage is necessary, the trustee has several potential avenues for obtaining financial assistance.

The trustee should also be aware of state and federal statutes relating to refitting, replacement, and monitoring of existing underground storage tanks on trust property, and financial responsibility requirements for operators of underground storage tanks. 42 USC §§6991-6991h; Health & S C §§25280-25299.8. Although lease provisions with lessees who operate gasoline service stations generally require the lessee-operator to comply with all government regulations, environmental law makes the property owner equally responsible for cleanup of any gasoline contamination resulting from failure to comply with such regulations. Thus, the trustee should inquire of the lessee-operator concerning compliance with environmental law and regulation.

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§6.24 B. Possible Sources of Financial Assistance for Investigation and Cleanup Costs

All previous owners or operators of the property who might have contributed to the contamination should be identified and notified of their potential liability. The State Water Resources Control Board will assist the trustee-owner of a contaminated service station by joining the operator-lessee as a PRP. Major oil companies often will pay for a cleanup in whole or in part if the trustee can show potential liability if pressure is applied by the Water Board. Patience and persistence are important in communicating with major oil companies.

Insurance policies that covered the property at any time during its use as a gasoline station may be located and reviewed for potential coverage. All insurance companies can be put on notice of potential liability, because coverage may exist under older policies. Any insurance claim must be pursued with persistence, because failure to respond and endless requests for further information are standard approaches by insurance companies to environmental claims.

The Underground Storage Tank Cleanup Fund, which is administered by the State Water Resources Control Board in Sacramento, provides financial assistance for environmental investigation and cleanup costs of contamination from both abandoned and currently utilized underground storage tanks. Health & S C §§25299.50-25299.63. The program grants priority to small businesses (Health & S C §25299.52(b)(2)(A)) and considers each trust estate a separate business, although related entities may be required to consolidate revenues for qualification. The qualification process is very slow, but the results can be gratifying. The program selects qualified applicants and pays for all reasonable cleanup costs, up to $1,500,000 per occurrence. Health & S C §25299.57. All testing and remediation work must be bid on by three or more contractors, and the successful bid must be approved by program administrators. 23 Cal Code Regs §2812.1. The property owner who qualifies as a small business must contribute the first $5000 of cleanup costs. Health & S C §25299.32(a)(2). Many major oil companies will advance cleanup funds to the trust if the trustee agrees to assign payments from the program to the oil company. Information concerning the program, including an application and instructions on its completion, can be obtained on the Internet from the State Underground Storage Tank Cleanup Fund Program through the State Water Resources Control Board Web site at http://www.swrcb.ca.gov.

If the property is leased, the lessee-operator should be obligated by contract to comply with environmental law and regulation and to pay the cost of cleaning up environmental problems it causes. See §6.14.

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V. ALLOCATION OF ENVIRONMENTAL EXPENSES UNDER THE UNIFORM PRINCIPAL AND INCOME ACT (UPAIA)

§6.25 A. Application of UPAIA

The trustee has a duty to treat income and remainder beneficiaries impartially in administering the trust and to take into account the differing interests of the beneficiaries. Prob C §16003; *Bowles v Superior Court* (1955) 44 C2d 574, 283 P2d 704. This duty raises the issue of proper allocation of the costs of environmental review, litigation, and cleanup between the income and principal accounts of the trust.

Under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), all disbursements related to environmental matters are allocated to principal, including expenses of (Prob C §16371(a)(7))

> reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.

Under UPAIA, remainder beneficiaries bear the burden of all environmental expenditures. Thus, under UPAIA, the trustee should allocate to principal the following payments, which might otherwise have been paid from income:

- Penalties for violation of environmental statutes or regulations payable by proprietorships held in trust;
- The cost of groundwater monitoring;
- Payments to environmental consultants; and
- 100 percent of attorney fees incurred by the trustee in prosecution or defense of environmental claims.

Any insurance payments or damages received by the trustee for an environmental claim should also be allocated entirely to principal under UPAIA.

On initial review, it may seem appropriate to allocate hazardous waste cleanup costs to trust principal, because it is generally a principal asset that benefits. However, cleanup costs can be substantial, and allocation of these costs entirely to the principal may seriously affect the remainder beneficiaries.

Moreover, the income beneficiary also benefits by the expenditure. In prior years the income beneficiary may have received income from the property that should have been used to prevent or clean up contamination of the property. Present trust income from contaminated property may be less than income from the same asset in a nonpolluted condition, if a tenant factors potential environmental liability into negotiations on rental price. Expenditures to ensure current environmental compliance of a business owned by the trustee may greatly increase the trust's future income. However, allocation of the entire cost of cleanup to income hurts the current income beneficiary to the benefit of the remainder beneficiaries.

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§6.26 B. Discretionary Powers Under UPAIA

In an attempt to permit a more equitable allocation of expenses, which would include environmental expenses, the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) allows the trustee to reallocate some portion of expenses to income. Prob C §16336. UPAIA exonerates from liability trustees who do not make a reallocation under Prob C §16336. Prob C §16336(h). The trustee may give notice of proposed action regarding a reallocation to the beneficiaries to avoid later claims against the trustee for any adjustment between income and principal. Prob C §16337.

Nevertheless, many trustees may be wary of making such an adjustment. As an alternative to making a discretionary adjustment, the trustee may consider creating a reserve from income for potential environmental expenditures that would benefit income beneficiaries. In annual accountings to beneficiaries, the trustee may wish to report the allocation of environmental expenditures between principal and income. On sale of property for which remediation costs were paid from income rather than principal, the trustee may consider allocating some portion of the sale proceeds to income.

Alternatively, the trustee may be able to convert the income interest to a unitrust interest with the consent of the beneficiaries or by court order under Prob C §§16336.4-16336.7. Expenses that would be deducted from income if the trust were not a unitrust are not deducted from the unitrust amount. Prob C §16336.4(e)(8).

If the trustee conducts a business or activity that is a sole proprietorship, the trustee may determine the extent to which net cash receipts of that business are accounted for as principal or income in the trust's general accounting records. Prob C §16352. Under this provision, the trustee may charge to income those environmental expenditures that are normal operating expenses of the business. Businesses and activities covered by this section include:

- Retail, manufacturing, service, and other traditional business activities;
- Farming;
- Raising and selling livestock and other animals;
- Managing rental properties;
- Extracting minerals and other natural resources;
- Timber operations; and
- Trading derivatives.

By using one or more of these discretionary powers granted by UPAIA, the trustee may plan for extraordinary environmental expenses (*e.g.,* removal of an underground storage tank or groundwater monitoring) and spread the financial burden of such disbursements equitably among the various beneficiaries of the trust.

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VI. TAX ISSUES RELATED TO CONTAMINATED PROPERTY

§6.27 A. Valuation of Contaminated Property for Property Tax and Estate Tax

If the trust contains property contaminated with hazardous waste, the trustee should be aware that property tax and eminent domain cases have approved a discount for lack of marketability in valuation of property contaminated with hazardous waste. However, there is no clear consensus on the proper method of valuation of such property. *Redevelopment Agency v Thrifty Oil Co*. (1992) 4 CA4th 469, 5 CR2d 687; *Firestone Tire & Rubber Co. v County of Monterey* (1990) 223 CA3d 382, 272 CR 745 (contaminated property revalued by following formula: fair market value under market data/sales approach, less reasonable cost of remediation). For a detailed discussion of valuation of contaminated real property, see *Custom Distrib. Servs., Inc. v City of Perth Amboy (In re Custom Distrib. Servs., Inc.)* (Bankr NJ 1997) 216 BR 136, remanded on other grounds (3d Cir 2000) 224 F3d 235. Of particular value is Simons, When Bad Things Happen to Good Property, chaps 2-7 (2005), which provides a complete discussion of valuation issues relating to contaminated property. See also Davis, Brownfields: A Comprehensive Guide to Redeveloping Contaminated Property, chap 6 (2d ed 2002).

The Tax Court has similarly approved the application of a lack-of-marketability discount to contaminated property for estate tax valuation. *Estate of Eleanor O. Pillsbury*, TC Memo 1992-425 (real property contaminated with hazardous waste may be discounted in value for estate tax if reasonable buyer would have taken such contamination into consideration at date of death). In *Estate of Dominick A. Necastro*, TC Memo 1994-352, the Tax Court also provided a measure for contamination discount. The value of the property was decreased by the reasonable cost of cleaning up contamination known to exist at the date of death. The *Necastro* court refused to allow a further discount for potential "contamination stigma"—the decrease in value due to fear of contamination—because the taxpayer had failed to prove that a purchaser of property in 1985 would have considered solid waste a potential liability. However, the court left the door open for recognition of contamination stigma on more compelling facts. See also *Eugene D. Lanier*, TC Memo 1998-7, in which the Tax Court rejected contamination stigma as an element in valuation of land with underground storage tanks because the taxpayer had failed to prove that a prospective buyer would discount the purchase price of the property due to existence of the tanks.

The Tax Court has also approved a lack-of-marketability discount regarding the value of closely held corporate stock when the corporation had clearly identifiable environmental liability at date of death. *Estate of William J. Desmond*, TC Memo 1999-76. In *Estate of Emily F. Klauss*, TC Memo 2000-191, the Tax Court quantified this discount, deducting the projected cost of statutory fines, remediation expenses, environmental consulting fees, and attorney fees from the undiscounted value of the stock. Expanding the scope of lack-of-marketability discounts for environmental problems even further, the Tax Court has also stated that environmental problems of real property are a relevant factor in valuing a promissory note secured by a deed of trust on that property. *Estate of Morton B. Harper*, TC Memo 2002-121.

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§6.28 B. Income Tax Treatment of Environmental Expenses

The trustee should be sensitive to the income tax treatment of environmental expenditures, because different interests in the trust are affected by different tax treatments of these frequently substantial amounts.

Under IRC §198, the trustee may deduct certain "qualified environmental remediation expenditures," as defined in the Code, as an ordinary business expense. Section 198 applies to expenditures paid or incurred after August 5, 1997, and before January 1, 2010. IRC §198(h). As of this writing, a bill is pending in Congress to make §198 permanent. HR 3260 (2009).

Environmental expenses not covered by §198 are subject to complicated (and still evolving) rules set forth in Revenue Rulings and Private Letter Rulings by the Internal Revenue Service. Under Rev Rul 94-38, 1994-1 Cum Bull 35, and related case law, environmental expenditures, including environmental consulting fees and cleanup expenses, are currently deductible business expenses if they meet the following conditions: first, the property was acquired in a clean state and polluted during ordinary business operations; second, the site was restored to its precontamination condition; and third, the cleanup did not allow the property to be put to a new use. See *United Dairy Farmers, Inc. v U.S.* (6th Cir 2001) 267 F3d 510, 519. All other environmental expenditures must be capitalized. See Rev Rul 2005-42, 2005-2 Cum Bull 67 (environmental remediation costs that are more in the nature of repairs (*e.g.*, costs incurred to clean up land and to treat contaminated groundwater) are deductible as business expenses; costs that are more in the nature of capital improvements (*e.g.*, construction of groundwater treatment facility) must be capitalized). It is unclear whether property contaminated by a settlor and then transferred to a trust would qualify if the ownership period of the settlor as an individual were combined with that of the current trustee.

Similar rules apply to removal of underground storage tanks. ISP Coordinated Issue Paper: Petroleum Industry—Replacement of Underground Storage Tanks at Retail Gasoline Stations (Jan. 9, 1998); Rev Rul 98-25, 1998-1 Cum Bull 998. However, asbestos removal costs are capital expenditures. *Norwest Corp. & Subsidiaries* (1997) 108 TC 265.

Because many environmental costs are paid from principal under Prob C §16371(a)(7) of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), the trustee may wish to develop a procedure for identifying such expenditures to ensure their deduction on the fiduciary income tax return. Environmental expenses that are capitalized should be added to the tax basis of depreciable property.

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Recordkeeping and Accounting

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I. TRUSTEE'S DUTY TO KEEP AND RENDER ACCOUNTS AND FURNISH INFORMATION

§7.1 A. Statutory Information Requirements

Trustees have a duty under Prob C §§16060, 16062, and 16064 to account to beneficiaries and to maintain and provide them with information about the trustee's administrative decisions and acts. Keeping detailed and accurate records ensures that the trustee can fulfill these duties both routinely and on demand. Good records are the best means of protection against liability in case beneficiaries question the propriety of an administrative act. Records should be thorough, legible, and easily accessible and should provide a cumulative description of the trustee's administration. See §2.4.

Probate Code §16064 requires in most cases that the trustee give beneficiaries regular accounts that contain specific kinds of information. The exceptions are discussed in §§7.54, 7.57. When asked by a beneficiary for information, the trustee must supply information concerning the assets, liabilities, receipts, and disbursements of the trust, the acts of the trustee, and other facts affecting the beneficiary's interest. Prob C §16061.

Probate Code §16060 states: "The trustee has a duty to keep the beneficiaries of the trust reasonably informed of the trust and its administration." Such beneficiaries include remainder beneficiaries who may not otherwise be entitled to an account under Prob C §16062. See §7.54. The California Law Revision Commission (CLRC) Comment to Prob C §16060 states: "The trustee is under a duty to communicate to the beneficiary information that is reasonably necessary to enable the beneficiary to enforce the beneficiary's rights under the trust or redress a breach of trust." Although information may have been provided to or been made available to the beneficiary under Prob C §§16061 and 16062, this "does not negate the affirmative duty of the trustee to provide information under Section 16060." Comment to Prob C §16061. One court has stated that "[t]he duty to provide information under §16060 is independent of, and potentially broader than, the duty to account under Prob C §16062." *Salter v Lerner* (2009) 176 CA4th 1184, 1188, 99 CR3d 1, citing California Trust and Probate Litigation §13.1 (Cal CEB 1999). The court held that a proposed petition seeking only information reasonably necessary for contingent remainder beneficiaries to enforce their rights under the trust and specifically not seeking an accounting under Prob C §§16061 and 16062 (which had been waived in the trust instrument) did not violate the trust's no-contest clause under former Prob C §21305(b).

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons) and which trusts will have total assets of more than $20,000 after receipt of those funds—the trust instruments must require the trustee to file accounts and reports for court approval in the manner and frequency required by Prob C §§1060-1064 and Prob C §§2620-2628. Cal Rules of Ct 7.903(a)(1), (c)(6), (d).

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§7.2 B. Consequences of Failure to Keep and Render Accounts

Trustees who fail to keep proper records or fail to account to the beneficiaries or the court when required can be held liable for breach of fiduciary duty, contempt, damages and, where appropriate, attorney fees. See Prob C §§16060, 17200(b)(7), 17211(b); CCP §1209(a)(5). A court order compelling the trustee to submit an account or report acts as trustee is not appealable. See Prob C §1304(a)(1). No statutes of limitation begin to run on undisclosed acts. See §7.64A. Furthermore, without proper records, the trustee will be unable to prepare accurate income tax returns for the trust, inviting further liability for violating both state and federal tax law.

If the trustee fails to keep proper records, all presumptions will be against the trustee and all doubts arising from the failure to keep records will be resolved against the trustee. *Purdy v Johnson* (1917) 174 C 521, 163 P 893; *Estate of McCabe* (1950) 98 CA2d 503, 220 P2d 614; Restatement (Third) of Trusts §83, Comment a (2007); Restatement (Second) of Trusts §172, Comment b (1959). On the other hand, the trustee has the presumption of good faith and regularity, so once the trustee has presented the account and produced evidence to substantiate its correctness, the burden of proof then shifts to the objector. *Neel v Barnard* (1944) 24 C2d 406, 420, 150 P2d 177 (distinguishing *Purdy v Johnson, supra*).

The beneficiaries can discover all records of the trustee's administrative actions or the lack of such records. See *Strauss v Superior Court* (1950) 36 C2d 396, 224 P2d 726; *Union Trust Co. v Superior Court* (1938) 11 C2d 449, 81 P2d 150; *Mota v Superior Court* (2007) 156 CA4th 351, 67 CR3d 303. Thus, the lack of detailed records is an inadequate defense to an action for trust mismanagement. See *Estate of McCabe, supra*. Summary or net figures are likewise insufficient disclosure. *Estate of Schneider* (1979) 95 CA3d 55, 57, 156 CR 838. Moreover, a trustee who lacks records to validate disbursements on behalf of the trust may be ordered to reimburse the trust for disputed amounts. See *Estate of McCabe, supra*.

Similarly, if the court finds that a person (including a trustee) has in bad faith wrongfully taken, concealed, or disposed of property belonging to the trust, that person may be liable for twice the value of the property received. See Prob C §859. Note that a surcharge for breach of fiduciary duties for defalcation (failure to account for money or property), whether innocently, intentionally, or negligently, may not be discharged in bankruptcy. *Swilhart v Starzer (In re Starzer)* (Bankr ED Cal 2005) 331 BR 444.

CAUTION: It is erroneous to assume that the trustee has no duty to account to any other person, or to disclose the trustee's actions, if the trustee is the sole present beneficiary of the trust. The unpublished decision in *Taubman v U.S. Bank* (Oct. 24, 2007, B177712, B185170; not certified for publication) 2007 Cal App Unpub Lexis 8594 resulted in an $8.8 million surcharge plus an award of attorney fees against the trustee-beneficiary of a trust based on an unexpired contingent beneficial interest combined with trust language requiring equalization of interests between two subtrusts. The opinion gives an excellent historical review of the law applicable to awards of attorney fees in surcharge and trust accounting actions.

Finally, a court might find a trustee who failed to keep adequate records unfit for the office and order the trustee removed. See Prob C §§15642, 16420, 17200(b)(10). The court has jurisdiction to suspend the trustee without a formal petition for removal in the course of review of a trustee's petition to approve the trustee's account and pass on the trustee's acts under Prob C §17200(b)(5). *Schwartz v Labow* (2008) 164 CA4th 417, 78 CR3d 838. See §15.44A. See also chap 4 on removal.

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§7.3 C. Attorney's Role in Recordkeeping and Accounting

Regardless of the size or complexity of a trust, the trustee is ultimately responsible for keeping records to provide information to the beneficiaries, to prepare accounts, and to prepare tax returns. The trustee's attorney should determine whether an individual trustee is capable of adequately performing accounting and recordkeeping duties. For a sample letter to the trustee regarding recordkeeping, see §7.14. An attorney who doubts the trustee's abilities should suggest that the records be brought to the attorney periodically for review so that errors or simple noncompliance can be corrected before any harm is done. Alternatively, the attorney may advise the trustee to hire a bookkeeper or an accountant to keep the records. Agents are useful alternatives not only for management purposes but also as record keepers (*e.g.,* brokerage firms or trust companies for securities and property management firms for real estate holdings). See §§7.9-7.12.

Under the attorney-client privilege, confidential communications between the attorney and the trustee regarding trust administration are protected from discovery by beneficiaries, and the work product doctrine protects the attorney's work product not communicated to the trustee. *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 91 CR2d 716. See also *Eddy v Fields* (2004) 121 CA4th 1543, 18 CR3d 487 (if work product privilege was waived by attorney with respect to predecessor trustee, it was also waived as to successor trustee).

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D. Shared Duties of Cotrustees

§7.4 1. Individuals Acting as Cotrustees

Many individuals acting as cotrustees may encounter administrative problems, particularly when great distances separate them. The trust document should be reviewed carefully to determine what acts may be delegated to one of the cotrustees for ease of administration. Unless the trust instrument provides otherwise, cotrustees must act jointly. Prob C §15620. See §§7.7-7.8 regarding actions of corporate cotrustees, and §3.4 regarding delegable duties. See also *Blackmon v Hale* (1970) 1 C3d 548, 83 CR 194 (liability of cotrustee who surrenders assets to exclusive control of cotrustee).

Permissible delegation is not limited to the performance of ministerial acts, but in appropriate circumstances may extend to discretionary acts. Restatement (Third) of Trusts §80, Comment e (2007); see §2.19. All delegations should be in writing and can be included in the cotrustees' agreement form in §7.6.

All trustees should endorse receipts before deposit because they must act jointly; when this is impracticable, they should try to work out an arrangement with a financial institution to accept for deposit checks endorsed by only one trustee. Most institutions have their own forms and internal procedures, which can be ascertained in advance.

Disbursements can also be problematic, time consuming, and costly for trusts with a large volume of financial activity. The best solution is for one trustee to make all routine trust payments. The trustee can make nonroutine payments in consultation with the other cotrustees or send them checks to sign.

PRACTICE TIP: The payer can send many recurring deposits directly to the financial institution, eliminating the need for endorsement. Most financial institutions will accept a receipt marked "for deposit only" unless it is a certain type of check, *e.g.,* one from the IRS, which requires endorsements of all payees. If a brokerage firm is being used as a custodian for trust assets, use an account on which the trustees can write checks. The brokerage account could be used for large or unusual payments, which all trustees would sign. A checking account could be used for routine payments requiring the signature of one trustee. Many brokerage firms allow automatic monthly transfers to be made to another financial institution, *e.g.,* to the checking account used for routine trust payments. The form authorizing the transfers from the brokerage firm requires the signatures of all trustees.

If the trustees delegate one of them to be responsible for routine receipts and disbursements, that trustee should be required to report to the other trustees periodically. The volume of disbursements could dictate the frequency of reporting. For most trusts a monthly report is sufficient. The administrative agreement between the cotrustees should be in writing and should carefully delineate the trustee's authority and responsibilities. See §7.6.

Care must be taken in the selection of cotrustees. The selection of a non-U.S. person as cotrustee will make a U.S. trust a foreign trust. IRC §7701(a)(30)(E), (a)(31)(B). Failure to meet the reporting requirements for foreign trusts (*e.g.,* IRS Forms 3520 and 3520A) may subject the trust to penalties of up to 35 percent on trust assets. IRC §6677(a). For a detailed discussion of foreign trusts, see Drafting California Irrevocable Trusts §§3.68-3.75 (3d ed Cal CEB 1997).

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§7.5 a. Anticipating Disagreements

If individual cotrustees disagree about who will collect funds, make payments, and keep financial records, the bookkeeping duties will become inefficient. Many financial institutions will send a copy of the account statement to a third party, but only one address can be used for receiving canceled checks.

NOTE: If the trustee is using online banking, some institutions will attach copies of canceled checks to the back of the statement.

If there is disagreement among the cotrustees, the attorney(s) should consider negotiating an arrangement in which one cotrustee will keep the books and report periodically to the others. Such an agreement should be in writing to prevent misunderstandings. The agreement should detail the authority and responsibilities of the trustee who is keeping the books. See §7.6 for a sample agreement that can be modified to provide for recordkeeping functions only or to include authority to receive and pay out funds. See §3.6 for further discussion of disagreements among cotrustees.

Cotrustees of revocable trusts should consider asking the settlor to amend the trust to allow cotrustees to delegate to one cotrustee duties such as signing checks and making deposits.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.6 b. Form: Agreement Between Cotrustees on Recordkeeping and Accounting Responsibilities

§7.6 b. Form: Agreement Between Cotrustees on Recordkeeping and Accounting Responsibilities

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AGREEMENT

_ _[*Name of trust*]_ _

_ _[*Date of trust*]_ _

It is agreed between _ _[*name of trustee*]_ _ and _ _[*name of cotrustee*]_ _, as cotrustees of the _ _ _ _ _ _ trust, that _ _[*name of trustee*]_ _ shall have responsibility for the following activities and shall maintain the following records on behalf of the trustees:

Disbursements/Receipts/Accounting

1. _ _[*Name of trustee*]_ _ shall make the following payments (or disbursements) on behalf of the trustees on an ongoing basis without the prior approval of _ _[*name of cotrustee*]_ _, but shall make no other disbursement without the prior written consent of _ _[*name of cotrustee*]_ _. In no event shall any payment in excess of $_ _[*dollar amount*]_ _ be made without the prior written consent of _ _[*name of cotrustee*]_ _.

a. Regular payments to income beneficiaries (or named persons) in accordance with the terms of the trust instrument,

b. Taxes,

c. Insurance,

d. Attorney and accountant fees,

e. Trust expenses, and

f. Payments for purchases of assets.

2. _ _[*Name of trustee*]_ _ shall collect all income and principal owed to the trust and deposit such sums promptly in the trustee checking account _ _[*or other designated account*]_ _. Such collections shall include, but not be limited to:

a. Dividends and interest;

b. Rentals;

c. Refunds on taxes, insurance, etc.;

d. Proceeds from sales of assets; and

e. Any other funds due the trust.

3. _ _[*Name of trustee*]_ _ shall provide a _ _[*e.g., monthly*]_ _ detailed financial report of all receipts and disbursement to _ _[*name of cotrustee*]_ _ and a _ _[*e.g., monthly*]_ _ report of same to the _ _[*income/designated*]_ _ beneficiaries. _ _[*Name of trustee*]_ _ shall provide a _ _[*e.g., monthly*]_ _ list of assets to _ _[*name of cotrustee*]_ _ and a _ _[*e.g., monthly*]_ _ list of assets to the _ _[*income/designated*]_ _ beneficiaries.

4. _ _[*Name of trustee*]**_ _ shall provide copies of all necessary records on a timely basis to the trust's accountant so that _ _**[*he/she*]**_ _ may prepare the trust's state and federal tax returns.**

5. _ _[*Name of trustee*]**_ _ shall keep the following records in an orderly and accessible manner:**

a. All bank statements and canceled checks for all accounts maintained by the trustees;

b. All tax returns and other tax information _ _[*e.g., documentation of the trust's generation-skipping transfer tax exempt status*]**_ _;**

c. Statements _ _[*or ledgers*]**_ _ of all receipts and disbursements;**

d. All confirmations of purchases and sales of securities and all statements from stock brokers detailing the transactions for the trust;

e. All bills, vouchers, copies of checks deposited, and other documents pertaining to assets belonging to the trust;

f. All correspondence from and to beneficiaries regarding matters pertaining to the trust, including copies of any notices sent;

g. All records of trustee's exercise of discretionary powers, including any decision on investments; and

h. _ _[*Specify any other records made necessary or convenient because of particular assets or trust needs*]**_ _.**

6. _ _[*Name of trustee*]**_ _ accepts responsibility for the above actions as a delegation of clerical functions only under article _ _**[*number*]**_ _ of the trust instrument dated _ _**[*date of instrument*]**_ _ and not a delegation of any discretionary power that must be exercised by all trustees acting together. _ _**[*Name of cotrustee*]**_ _ agrees that having _ _**[*name of trustee*]**_ _ perform these functions does not relieve _ _**[*him/her*]**_ _ of _ _**[*his/her*]**_ _ responsibility or liability as trustee for these funds or records, other than as provided in the trust instrument dated _ _**[*date of instrument*]**_ _.**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: This form can be easily adapted if there are more than two cotrustees.

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2. Corporate Trustee Acting With Individual Cotrustee

§7.7 a. Responsibilities of Corporate Trustee

Virtually all corporate trustees keep trust records on a computer system that records receipts and disbursements chronologically and maintains current lists of assets held, with cost-basis information, and monitors their movement (*e.g.,* sale, purchase, exchange, and tender). Easy retrieval of this data greatly facilitates accounting and tax return preparation.

Because national bank corporate trustees are required by Regulation 9.8 of the Comptroller of the Currency to keep the financial records of the trust (12 CFR §9.8), they must do so for those trusts they administer jointly with individual cotrustees. It is logical for the corporate cotrustee to be the one to collect and disburse funds because of the professional and technical staff at its disposal and computer capabilities.

Financial Code §1582 governs the responsibility of corporate trustees to disclose information. There is no comparable statute governing the responsibilities of an individual trustee, but the attorney for the individual may wish to review the section for guidelines. See also Restatement (Second) of Trusts §170(1), Comment s (1959). For further discussion, see §§2.28-2.29.

When an individual cotrustee objects to the national bank corporate trustee's preemption of these functions and insists on participating in collecting and accounting for funds, the corporate trustee is caught between the cotrustee's right to do so and the requirements of the regulations. Under 12 CFR §9.8, the corporate trustee should review in detail any work performed by the individual cotrustee. Such duplication of effort adds to the costs of administration and should be discouraged. In most corporate and individual cotrusteeships, unwieldy and expensive administrative redundancy can be avoided if the corporate cotrustee provides the individual cotrustee with periodic statements of all trust activity and gives advance notice of all proposed actions. If, however, the matter cannot be worked out between the cotrustees, the best solution might be for one or both of them to resign.

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§7.8 b. Ministerial Functions of Corporate Trustee

Corporate trustees routinely deposit and issue checks not endorsed or signed by the individual cotrustee with whom they administer a trust. Although all trustees share legal responsibility for proper receipt and disbursement of trust funds, the act of drawing or depositing a check—as opposed to making the decision requiring the check—is a clerical function that can properly be delegated as "ministerial." See §§2.18-2.19, 7.4. Checks payable to the trust can be deposited by the financial institution without the individual cotrustee's endorsement. Neither trustee endorses dividend checks for securities held in nominee registration.

Corporate trustees, for example, routinely issue periodic income payments to beneficiaries and pay utility bills with checks not cosigned by the individual trustee. Depending on the cotrustees' agreement, less routine payments may require consultation with the individual trustee before being disbursed. If an individual trustee insists on cosigning all checks, however, the corporate cotrustee must comply. See Prob C §15620. Trust funds needed to meet current expenses can be channeled into a checking account. All checks drawn on that account must be signed both by an officer of the corporate trustee and by the individual cotrustee. This procedure causes delay, and the added costs to the trust are ultimately borne by the beneficiaries.

Many financial institutions may, because of potential liability, refuse to handle an account on which one of several cotrustees can independently draw checks. See *Bullis v Security Pac. Nat'l Bank* (1978) 21 C3d 801, 148 CR 22, in which the court held the bank liable for misappropriations of estate funds when one coexecutor was allowed to draw checks without the signature of the other. The court found this practice contrary to the provisions of former Prob C §570, which permitted one of two coexecutors to act alone only when the other coexecutor was out of state or legally incompetent to act. Although this case concerned coexecutors, similar principles apply to cotrustees under Prob C §15620. That section requires unanimous cotrustee consent to act absent contrary trust provisions, except in cases of temporary incapacity. See §3.5.

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§7.9 E. Delegation of Duties to Keep and Render Accounts

Many individual trustees have purchased personal computer systems with financial management software packages on which the trust records can be kept. Some trustees, of course, must still resort to cumbersome manual systems for keeping financial records. For trusts with a few simple assets such as stocks, bonds, and a residence, a ledger is adequate for recordkeeping. See §7.44. For trusts with a large number of assets, complicated provisions for disbursement to beneficiaries, depreciation schedules, or accumulation provisions, a ledger system is cumbersome and time-consuming. Recordkeeping in such cases should be delegated to an agent.

In practice, the responsibility for keeping the financial records for the trust is often delegated to a bookkeeper, an accountant, an attorney, or a financial institution. The sample agreement at §7.6, authorizing one cotrustee to perform recordkeeping functions, can be modified to reflect the third party's responsibility for recordkeeping or other duties, including income collection and disbursements. If the third party has its own form of agency agreement and insists on using it, the attorney for the trustee should insist on language limiting the agent's actions to ministerial functions, unless the trustee specifically wishes to delegate certain management functions. Probate Code §16012(b) states: "In a case where a trustee has properly delegated a matter to an agent, cotrustee, or other person, the trustee has a duty to exercise general supervision over the person performing the delegated matter." See also Prob C §16063(a)(4), which states:

> An account furnished pursuant to Section 16062 shall contain … [t]he agents hired by the trustee, their relationship to the trustee, if any, and their compensation for the last complete fiscal year of the trust or since the last account.

For further discussion of delegation of duties to agents, see §§2.18-2.20.

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§7.10 1. Agents for Investment Management

The Uniform Prudent Investor Act (UPIA) (Prob C §§16002(a), 16003, 16045-16054) encourages individual trustees who are not sophisticated investors to seek professional investment advice. Although active investment management is discouraged in favor of a more passive approach (*e.g.,* through broad-based index funds), many trustees need advice and assistance with investment basics such as development of investment goals and objectives for the trust and appropriate asset allocation. Reports from investment managers for the assets they manage can be helpful to the trustee and will include, at the very least, a description of the current assets, purchases and sales during the reporting period, and the income produced by the assets. These reports can be summarized and the information incorporated in an informal account to the beneficiary.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.11 2. Agents for Property Management

§7.11 2. Agents for Property Management

Property management firms usually generate reports that show the income and expenses for each property the firm manages. These reports are often extensive, and it is not productive to reenter every item in a separate accounting to the beneficiary. Inclusion of the net income in a receipts schedule, along with a copy of the report, will provide the information the trustee is required to furnish to the beneficiary. The trustee may account separately for rental properties in a noncourt accounting. Prob C §16352(c)(4). For court accountings, the net income or loss must be included on the schedule described and shown in §7.90.

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§7.12 3. Agents for Custody of Assets

All trustees should be encouraged to keep liquid assets at a financial institution. Doing so makes recordkeeping much easier and eliminates problems associated with recovering lost dividend and interest checks. If the trustee is managing the investments, a brokerage firm or trust company will act as custodian of the trust assets. Fees for trust company custody accounts are higher than those for brokerage accounts (which are often free), but a trust company will track principal and income separately, which is helpful if the trust is a net income trust.

NOTE: If the custody account is nondiscretionary (a type of account with no investment management), the custodian needs to be told whether distributions are to be allocated to principal, to income, or both. In most cases, a trust company responsible for investment management will allocate receipts and disbursements between principal and income on behalf of the trustee according to the trust terms or the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). See Prob C §16335(a).

If the trustee delegates investment management, the investment management firm often has arrangements for custody of assets under its management, the cost for which is included in the investment management fee.

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II. RECORDKEEPING

§7.13 A. Advising Client to Establish Recordkeeping System

The trustee must have accurate financial data to prepare trust tax returns, to account to the beneficiaries and the court, and for tax planning. Trust records should show the following:

- Amounts received and spent and the allocations to principal, income, or both (see §§7.41-7.44 and chap 8); and
- Inventory of all trust assets, including:
- Current valuation (see §7.25);
- Cost basis (see §§7.26-7.32);
- Periodic market valuations of securities;
- Gains and losses incurred on sale of assets and other dispositions; and
- Tax elections such as subchapter S for corporations or IRC §754 for partnerships or LLCs.

Records of all transactions must be retained and organized to reflect their connection to the above data, *e.g.:*

- Canceled checks, paid invoices, and receipts;
- Bank statements;
- Fiduciary income tax returns; and
- Tax audit reports.

See §§7.45-7.49 regarding computerized recordkeeping of receipts and disbursements.

The individual trustee may file trust records with a system of folders. A separate folder is maintained for each of the following categories:

- A copy of the trust instrument and all amendments and documents affecting the terms of the trust (see §7.15);
- Copies of all court orders pertaining to the trust;
- Notices sent to beneficiaries and others, along with dates of mailing or delivery;
- Cost-basis information;
- Property tax information;
- Completed discretionary action forms and information regarding to whom and why the discretionary payments were made, or why the transfer between principal and income was made;
- Information evidencing compliance with the Uniform Prudent Investor Act;
- Bank statements and canceled checks;
- Deposit slips and other income items;
- Paid bills;
- Copies of tax returns;
- Copies of generation-skipping transfer tax exemption allocation information, if applicable;
- Status of assets (or, depending on their number and complexity, one folder for each asset), including confirmations of purchases and sales;
- Transactions of any business operated by the trust;
- Reports to Attorney General, if the trust is a charitable trust;
- Correspondence and memoranda of a routine nature; and
- All correspondence and memoranda in connection with the above or other actions of the trustee that might be called into question later.

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§7.14 B. Form: Letter Advising Trustee What Records to Keep

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_ _[*Date*]_ _

Dear _ _ _ _ _ _,

As a trustee, you have a responsibility to keep complete and accurate records of your actions. You will need these records to show the beneficiaries that all of your actions have been performed with the best interests of the trust in mind and according to law and the terms of the trust. The accountant you have selected to prepare the trust's federal and state income tax returns also needs records. To fulfill your responsibilities as trustee, you should maintain the following records:

1. Detailed ledgers showing all funds received and paid out.

[*If appropriate, add*]

I enclose a sample ledger to suggest how to do this. Many computer accounting programs do an excellent job of keeping these records far more efficiently than by hand. You may wish to discuss use of such a program with your accountant, who can aid you in setting up the program to be consistent with your accountant's method for income tax reporting and trust accounting.

[*Continue*]

2. Copies of all bank statements and canceled checks for all accounts maintained by you as trustee and copies of all checks deposited.

3. All tax returns _ _[*include, e.g., a copy of the estate/gift tax return allocating the generation-skipping transfer tax exemption to the trust.*]**_ _.**

4. All confirmations of purchases and sales of securities and all statements from your broker detailing all transactions for the trust, and all information showing the cost of assets.

5. Copies of all bills and receipts.

6. All correspondence from any persons, or to any persons, concerning the trust.

7. All records of discretionary actions undertaken by you authorized by the trust terms.

[*If appropriate, add*]

I enclose a sample, suggested form for you to use.

[*Continue*]

8. A trust synopsis that contains information a successor trustee would need to know immediately if something happened to you and that can serve as a reference for you.

9. Lists of the assets in the trust, updated as changes take place, identifying the name on title or on the account, account numbers, addresses and telephone numbers of account representatives, date account opened or asset purchased, and any special tax elections pertaining to assets (*e.g.,* subchapter S election, IRC §754 election in partnership or LLC). For California real property, keep a list of purchase dates or new construction and assessed values as of those dates (base-year values), and similar information for any closely held legal entities owning California real property.

[*If appropriate, add*]

Identify whether any property is the separate property of one of the spouses, as opposed to the community property of both spouses.

[*Continue*]

10. _ _[*Specify any other records appropriate to the particular trust*]_ _**.**

If you have any questions about what records to keep or how to keep them, feel free to contact me.

Sincerely,
__[*Signature of attorney*]__

Comment: For a form of record of discretionary actions provided in Item 7, see §7.34.

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C. Documents and Other Information to Keep

1. Trust Terms and Other Documents

§7.15 a. Original Trust Instrument

The original trust instrument (usually "declaration of trust" if the settlor was also the initial trustee; "trust agreement" if the settlor and trustee were different persons), including all amendments and documents affecting the terms of the trust, should be part of the records kept readily available by the trustee. Examples of documents affecting the terms of the trust include any exercise of a power of appointment, court order modifying or construing the terms of the trust, resignation of a trustee or appointment of a successor trustee, and external documents referenced by the trust instrument

The original trust instrument is not filed with the probate court. Because the original document is the best evidence of the trust's existence, it should be kept by the trustee in a safe place, such as a safe-deposit box. A copy of the original trust instrument, including all amendments and documents affecting the terms of the trust, should be in the attorney's and in the trustee's records.

If the original document is misplaced, lost, or destroyed, it will be more difficult to defend a challenge to the existence or validity of the trust. As a practical matter, however, there is little chance that any party could successfully challenge a trust if all the assets are in the trustee's name and that trustee has served in such capacity for an appreciable time.

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§7.16 b. Testamentary Trusts: Certified Copy of Decree of Distribution

The trustee should retain a certified copy of the decree or decrees of distribution establishing the trust and making distributions to it. A certified copy, while not strictly required, is preferable because it is more credible. The terms of the decree of distribution supersede the will, control, and are not subject to attack after the order becomes final. *Estate of Callnon* (1969) 70 C2d 150, 74 CR 250; *Estate of White* (1945) 69 CA2d 749, 160 P2d 204. See also *Estate of Colyear* (1970) 10 CA3d 670, 89 CR 147 (testator's intent as expressed in will was properly considered when decree merely incorporated terms of will). If the order does not include the terms of the trust but incorporates the will by reference, the trustee should also have a copy of the will on file.

PRACTICE TIP: The attorney should double check trust terms and dates to determine whether the trust is subject to ongoing jurisdiction under Prob C §17300, if not otherwise previously removed. See §15.2.

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§7.17 c. Resignations, Acceptances of Trustees

Resignations or acceptances of trustees evidence the trustee's authority to act. The originals are needed for many purposes, particularly to marshal trust assets or transfer them into the name of a successor trustee. They should be kept indefinitely. If a financial institution or agent demands the original, make certain it is returned as other institutions may also need the original.

PRACTICE TIP: The attorney for the trustee should ask the former trustee to provide duplicate originals. If there are no duplicates, the trustee should personally visit the financial institution having custody of the asset to be transferred. If this is not practical and the trustee uses the mail, he or she should always enclose a copy of the original resignation for the financial institution's records along with a stamped, addressed return envelope for the return of the original resignation.

In addition to the originals of resignations or acceptances of trustees, recorded certifications of trust (Prob C §18100.5(i)) and affidavits of change of trustee (Prob C §18105) should be retained and updated as needed.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.18 d. Court Orders Changing Trust Terms

§7.18 d. Court Orders Changing Trust Terms

If the trustee, or predecessor trustee, has clarified or changed any of the terms as they appear in the original trust (as amended), or the decree of distribution, these documents should be kept in the same file as the original trust terms.

PRACTICE TIP: To avoid following outdated trust provisions at a later date, line through the paragraphs in the original agreement with pencil to show that changes were made.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.19 2. Trust Synopsis

§7.19 2. Trust Synopsis

A synopsis is a written summary of important names, dates, and trust terms that acts as a ready reference. It should include the following:

- A summary of trust terms;
- The tax identification number of the trust;
- Tax elections or allocations to the trust, *e.g.,* estate or generation-skipping transfer tax exemption, QTIP, or qualified subchapter S trust election;
- The name, address, phone number, birth date, tax bracket, general health (if the trust ends on the death of a particular beneficiary), and social security number of each beneficiary entitled to present distributions of principal or income;
- The names, addresses, e-mail addresses, and phone and fax numbers of agents used by the trustee;
- The names, addresses, and phone numbers of remainder persons;
- The names, addresses, e-mail addresses, and phone and fax numbers of contacts frequently used.

The summary of trust terms should include all specific instructions to the trustee, *e.g.,* to consider other income of a beneficiary before exercising discretion. If an event triggers a change in beneficiaries or distribution of income, the type of event should be noted (*e.g.,* the death of an income beneficiary). If the trigger date is known (*e.g.,* the date a beneficiary reaches a certain age), the date should be noted. The summary should also include provisions that may affect the amount distributable to a beneficiary (*e.g.,* a tax clause that directs payment of the tax from the residue, as opposed to equitable proration).

If the trustee is acting as trustee in several trusts, it is useful to summarize those terms that distinguish the trust in question from those in other trusts that use the "boilerplate" language of trustee powers usually found in a trust document.

The synopsis acts not only as a reference for the acting trustee, but as a resource for a successor trustee, if one needs to step in quickly (*e.g.,* on the death or incapacity of the acting trustee). It is also useful to a new account administrator or paralegal who replaces one formerly charged with assisting with the administration of the trust. Although the Probate Code does not require such a document, in the author's opinion it makes administration easier and facilitates a change of administration when or if the trustee cannot act.

PRACTICE TIP: Each trustee should design his or her own form. It should make logical sense, and it should be in a form that can be updated easily. The attorney should have a current copy in his or her files.

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§7.20 a. Beneficiary Information

The attorney should advise the trustee to obtain accurate names, addresses, and Social Security numbers of income, remainder, and contingent beneficiaries. The trustee will need this information to account to them and to the court (if applicable) and to give required notices when petitioning under Prob C §17200. See Prob C §17203. The trustee may not need to communicate regularly with remainder or contingent beneficiaries (Prob C §16062; see §7.54), but will have to locate them promptly when the trust terminates or when their interests become current. See Prob C §§16061.5, 16061.7. In addition, this information will be necessary to provide notification of the trust administration under Prob C §16061.7 for irrevocable trusts. See §§2.5-2.12.

PRACTICE TIP: When a beneficiary is not a U.S. citizen or is not a U.S. resident, there may be additional reporting, recordkeeping, and accounting requirements beyond the scope of this chapter. The attorney may wish to consult with international tax counsel to be advised of particular requirements or issues pertaining to the beneficiary's country of citizenship or residence. See Heimos, *Non-Citizens—Estate, Gift and Generation Skipping Taxation*, 837-2d Tax Management Portfolios (2005); Zaritsky & Rosen, *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries*, 854-3d Tax Management Portfolios (2008).

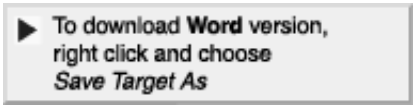
It is sometimes difficult to obtain the names and addresses of beneficiaries of revocable trusts, particularly if the settlor prefers to keep the existence of the trust from the beneficiaries. The beneficial interests might be changed or eliminated and unnecessary ill feelings could result from premature disclosure of an expectancy that does not materialize. In such cases, the settlor might not want the trustee to contact potential beneficiaries. The trustee could still obtain names and addresses by promising the settlor that he or she would have no premature communication with the prospective beneficiaries without the settlor's express permission.

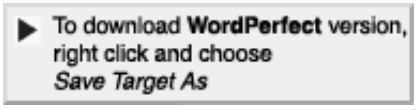
PRACTICE TIP: The trustee should maintain current information on the income needs and tax brackets of income beneficiaries and should know the approximate tax brackets of remainder beneficiaries. This information is necessary for the trustee to make appropriate investment decisions for all parties beneficially interested in the trust. If the trustee has an ongoing knowledge of the financial situation of all beneficiaries having the right to request discretionary payments from the trust, it will be easier for the trustee to make decisions about such payments. If the information is kept on a computer, it is useful to have the date the record was updated appear, a feature that can be automated in most word processing programs.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.21 b. Form: Letter to Beneficiary Requesting Information

§7.21 b. Form: Letter to Beneficiary Requesting Information





Dear _ _ _ _ _ _,

As you know, you have an interest in _ _[*this trust/these trusts*]_ _ as _ _[*an income/a remainder*]_ _ beneficiary. _ _[*I/We*]_ _ need to determine whether the trust's investment objectives are appropriate in light of your current needs, and at the same time take into consideration the future interests of the _ _[*other/remainder*]_ _ beneficiary(ies).

You may wonder why _ _[*I/we*]_ _ request information about your assets outside the trust(s). This information will enable _ _[*me/us*]_ _ to determine what type of trust investment will best meet your needs, including what proportion, if any, of taxable or tax-free assets would be most appropriate.

[*If appropriate, add*]

This information also will be helpful if you later request that discretionary payments be made to you.

[*Continue*]

In this regard, _ _[*I/we*]_ _ must consider many aspects of your personal and financial circumstances. It would be most helpful to _ _[*me/us*]_ _ if you would provide _ _[*me/us*]_ _ with as much of the following information as possible:

Types of assets (savings, real estate, stocks, bonds, etc.):

Estimated value of your outside assets: (List assets and estimate dollar value of each.)

Taxable and nontaxable income received other than from the trust(s):

Amount of federal and state individual income taxes paid _ _[*or federal and state income tax brackets*]_ _:

Top combined income tax bracket (federal plus state):

Your income needs from the trust(s):

Your birth date:

Your Social Security number:

Status of your health:

Your own feelings regarding an appropriate investment objective for the trust(s):

___ Emphasize income, or

___ Emphasize growth, or

___ Emphasize both equally.

You may use the enclosed copy of this letter for your response. A return envelope is also enclosed for your convenience.

Thank you for your assistance in providing _ _[*me/us*]_ _ with this information. If you have any questions about this or any other matter, please do not hesitate to let _ _[*me/us*]_ _ know.

Sincerely,
__[*Signature of trustee*]__

Comment: This letter can be modified or adapted to particular circumstances. The trustee can include a description of the trust or a copy of the trust instrument. The letter is designed to obtain information needed to make informed investment decisions and to make rational and equitable decisions on beneficiaries' requests for discretionary payments. It is also useful if the trustee is considering an equitable adjustment between principal and income under Prob C §16336 or §16375, or conversion of an income interest to a unitrust interest under Prob C §16336.4. The trustee should be cautious when asking sensitive questions. For discussion of the trustee's power to make adjustments between principal and income, see §§7.35-7.36.

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§7.22 c. Notice-of-Events Provision

The trust should be reviewed for the presence or absence of a "notice-of-events" provision. Such a provision protects the trustee from liability for distributions made before the trustee has knowledge of an event, for example, a birth, death, or marriage that alters the beneficiaries' rights. If there is no notice-of-events provision in a revocable trust, the trustee's attorney should recommend that the instrument be amended to add one. Although such a provision does not eliminate the trustee's responsibility to inquire about changes in the personal status of beneficiaries, it does provide some protection to the trustee and may allow the trustee to verify and update changes of status less frequently. For a form of provision, see §7.23.

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§7.23 d. Form: Trust Provisions for Notice to Trustee of Births, Deaths, and Other Events Affecting Interests

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Unless the trustee has received actual _ _[*written*]_ _ notice of the occurrence of an event affecting the beneficial interests of this trust, the trustee shall not be liable to any beneficiary of this trust for proceeding as though the event had not occurred.

[*If applicable, add the following option*]

[*Option: Trustee not relieved from liability for nonpayment of estate and GST taxes*]

This clause shall not exculpate the trustee from liability arising from nonpayment of estate taxes or generation-skipping transfer taxes that may be payable by the trust on the occurrence of an event affecting the beneficial interests of this trust.

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§7.24 3. Asset Information

The trustee may use any convenient and logical system for keeping track of trust assets. Some trustees list them alphabetically, others by category, *e.g.,* all stocks, all bonds, all real estate, all cash and cash equivalents. The list is more useful when it includes the cost basis of each asset. See §§7.26-7.32. Whatever its format, the list must adequately identify each asset. Consider whether the decedent is a "deceased personality" under CC §3344.1 whose name, voice, signature, photograph, or likeness has commercial value as an asset.

NOTE: When the settlor is married or has a registered domestic partner, the trustee should identify any assets that are the settlor's separate property, as opposed to community property, and keep separate accounting records for each type of property. This serves two purposes: The trust instrument may require separate property assets to be funded differently from community property assets; and such identification will reduce the risk of separate property assets losing their separate character by commingling.

Records of stock holdings should indicate the number of shares and whether the shares are preferred or common, *e.g.,*

100 shares XYZ Co., common;
100 shares ABC, Ltd., class B 6-percent preferred.

Records of bonds held by the trust should indicate par value, issuer, rate, and due date, *e.g.,*

$10,000 par value, City of Jackson, School Improvement, 5 percent, due Dec. 13, 2020.

Real property holdings should be recorded by street address (if available) or by legal description and geographical reference, *e.g.,*

40 acres approximately 13 miles east of Fresno, south of Kings Canyon Blvd.

Other classes of assets can require either more or less detail, *e.g.,*

14 miscellaneous U.S. gold coins (or itemize dates and values).

PRACTICE TIP: When an asset has been sold, the documentation should be filed with the income tax return that reports the sale to avoid the need to keep obsolete file folders.

Information pertaining to particular tax elections or status of particular assets should also be reflected on an asset list or other trust records. For example:

- Whether a closely held corporation is an S corporation;
- Whether an IRC §754 election has been made as to a partnership or LLC interest;
- The assessor's base year for real property (date of change in ownership; often date of purchase or new construction) and base-year value;
- Whether real property owned inside a family legal entity in which the trust has an interest will incur a change in ownership triggering reassessment under Rev & T C §64(d) (original co-owner transfer cumulatively more than 50 percent of entity's ownership interests) or Rev & T C §64(c) (change in control).

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§7.25 a. Market Value of Trust Assets

The trustee should update records of trust asset values. The frequency of updating will depend on the nature of the asset, its price volatility, the difficulty of obtaining the information, and the need for the information. For instance, securities should be valued frequently if they may be traded; a home retained for a beneficiary's use may need a valuation only infrequently, for insurance or possible sale purposes. Regularly traded securities can be valued from the closing financial quotations in newspapers, quotations from the trustee's stockbroker, or, if the trustee is using a computer, by various free services on the Internet. Current market values are required for accounts approved by the court. An individual trustee will receive periodic valuations for securities in statements from a custodian.

WARNING: Securities valuations from brokerage accounts are market values and are not to be confused with the acquisition values used in the Summary of Account. Some brokerage firms now include both values on their statements.

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§7.26 b. Cost Basis of Trust Assets

The trustee must keep accurate records of the cost basis of trust assets for both investment and tax purposes. The trustee therefore uses cost basis to make investment decisions, *e.g.,* whether an asset should be sold or, in some cases, distributed to a beneficiary, at a particular time. See Prob C §16047(c)(3); §§11.48-11.51. Basis information also enables the trustee to compute the capital gains or losses incurred on the disposition of trust property (by sale or otherwise) when preparing Schedule D for both federal and California fiduciary income tax returns.

PRACTICE TIP: Special rules may apply in certain transactions, *e.g.*, involving the related party second disposition rules under IRC §453(e), such that computation of gain or loss may require more basis information than simply the trust's cost basis or adjusted cost basis. The trustee will want to keep adequate records for these exceptions and perhaps notation of the applicable rules for making investment or distribution decisions.

Cost basis is the value used on an income tax return to calculate gain or loss on the sale of an asset. It is not ordinarily used in accountings unless the asset was received directly from a decedent's estate (as discussed in §7.30), the asset was community property in a joint revocable trust and one of the trustors has died, the asset was held in a single-trustor revocable trust and the trustor died, or the asset was purchased by the trustee during the course of his or her administration. In each of these instances, the cost basis will be the same as the fiduciary acquisition value. When the adjusted cost basis is equal to the purchase price or fiduciary acquisition value, the trustee should obtain and maintain records documenting these values.

Generally, the adjusted cost basis in the hands of the settlor is the basis used for assets transferred to a revocable living trust. Thus, if the settlor has basis records, the trustee simply incorporates the settlor's records into the trust records. See §7.31. Settlors, however, may fail to keep accurate basis records, particularly of adjustments to basis that may be necessary to bring the basis data current. The trustee will want to obtain the basis information and make inquiries sufficient to document the accurate adjusted cost basis of all assets soon after the trustee accepts the trust while the settlor's records and memories can be obtained. See §§7.27-7.29 on sources of information. See §7.32 on consequences of failure to obtain basis information.

WARNING: Do not confuse cost basis with fiduciary acquisition values (carry value), which may or may not be the same.

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(1) Sources of Information for Determining Basis

§7.27 (a) Securities Cost Information

If the settlor had a brokerage account, purchase dates of securities and their original cost may be obtained from the account statements. The date on an individual stock certificate may be a close approximation of the actual date of purchase.

WARNING: When there are more than one stock certificate, always use the oldest date in the group of certificates, because later certificates may represent stock splits, or dividends, rather than additional purchases.

The stock's history may be traceable through a capital change guide. A transcript of ownership may be obtained for a fee from most stock transfer agents. This transcript will show the dates certificates were transferred into the settlor's name. If the date of purchase can be ascertained, the quoted price of the security on that date may be obtained from stock brokers or online financial services. Certain stocks, particularly utility stocks, often include in dividends a return of capital, which is exempt for income tax purposes. Return of capital reduces the cost basis of the holding by the amount returned.

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§7.28 (b) Real Estate Cost Information

The best sources of information for the cost of real property are the escrow closing statement and escrow instructions, which provide all of the buyer's acquisition costs. If these are unavailable, the purchase price can be calculated from the documentary transfer tax stamps or declaration if this is shown on the deed. To calculate the purchase price from the documentary tax stamps or declaration, divide the tax paid by the applicable tax rate per thousand dollars of purchase price, and multiply that amount by $1000. For example, if the tax rate was $1.10 per thousand and the transferee paid $44 in transfer taxes, a purchase price of $40,000 is obtained as follows: $44 ÷ $1.10 = 40; 40 ´ $1000 = $40,000. The county recorder can provide the tax rate in force at the time of the transfer.

Another source for the purchase price is a copy of the sales contract or other contemporaneous writing documenting the amount. Furthermore, the assessor's index of records (often computerized) can show dates of sale and new construction, as well as appraised value as of those dates. With authorization, copies of filed preliminary change-in-ownership reports showing the sales price could also be obtained.

If the escrow instructions, documentary transfer tax information, and other documentation are all unavailable, and there are no other sources of this valuation, the trustee will have to use an estimated purchase price. To estimate the value, obtain the acquisition date from the county real property transfer records. An experienced real estate appraiser can review property sales records and estimate the value at the time of the acquisition. Similar comparable-sales information can be obtained from companies that market recording and property information, such as Real Quest (http://www.realquest.com) or Data Tree (http://www.datatree.com). The trustee can use this estimate to arrive at a tentative cost basis for the property, although, without actual documentation of the purchase price, the taxing authorities do not have to accept the value. See §7.32.

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§7.29 (c) Other Sources of Information

Canceled checks are an excellent source of information on the purchase price of any type of asset. If assets were inherited, court records of the probate administration can provide inventory values for such property. Property insurance schedules also may indicate historical value or purchase price.

Tax records are another excellent source of basis information. Information concerning the amount of any gift taxes paid on transfer of an asset to an irrevocable trust is also needed to determine basis. See §7.31.

If the settlor's records are unavailable, the trustee may obtain a copy of a decedent's federal estate tax or gift tax return from the Internal Revenue Service by filing IRS Form 4506 with the IRS service center where the requested return should have been filed initially. See IRC §6103(c). Alternatively, the request can be made by a letter to the IRS under IRC §6103(e) (also sent to the IRS service center where the requested return should have been filed initially) stating the reason the return is requested (specifically, that the party seeking disclosure has a material interest affected by the information in the return), the full name of the decedent or donor, the date of death or gift, and the social security or tax identification number on the return.

NOTE: Section 6103(e)(10) prohibits disclosure of "any supporting schedule, attachment, or list which includes the taxpayer identity information of a person other than the entity making the return or the person conducting the inspection or to whom the disclosure is made." Therefore, when possible, the request should be filed on behalf of persons whose identity may be listed on schedules or attachments that may be needed.

PRACTICE TIP: The IRS often will be unable to locate returns, so consider this approach a last resort. The person who prepared the return might be able to furnish a copy of the tax return.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.30 (2) Property Acquired From a Decedent

§7.30 (2) Property Acquired From a Decedent

Generally, for federal and state income tax purposes, the basis of an asset that was acquired from a decedent is the fair market value of the asset at the date of decedent's death. IRC §1014(a); Rev & T C §18031. Assets in a testamentary trust are, by definition, acquired from a decedent. IRC §1014(b)(1). Assets that are a part of a grantor trust or a revocable living trust that are included in a decedent's estate under IRC §§2036-2038 are considered to have been acquired from the decedent. IRC §1014(b)(2)-(3). Assets representing the surviving spouse's share of community property are also considered to have been acquired from the decedent (*i.e.*, both halves of the community property are stepped up in basis on the death of the first spouse). IRC §1014(b)(6). Similarly, assets of a QTIP trust includable in the taxable estate of the surviving spouse under IRC §2044 are considered to have been acquired from the decedent. IRC §1014(b)(10). However, income in respect of a decedent (IRD) is not. IRC §1014(c). In addition, certain adjustments may be required under IRC §1014(b)(9)-(10) and IRC §1014(d).

NOTE: Assets representing a surviving registered domestic partner's share of partnership community property may be considered as acquired from the decedent for state income tax purposes, but not for federal income tax purposes. Under Rev & T C §18031 (applying IRC §1014(b)(6)) registered domestic partners are treated as if federal law recognized a domestic partnership in the same manner as California law. See Fam C §297.5(e). See also Rev & T C §§17024.5(h)(2), 18521 (registered domestic partners file joint state income tax returns). However, same-sex registered domestic partners are not treated as spouses for federal income tax purposes. See 1 USC §7. See also IRS Legal Memorandum 200608038 (no income splitting on federal individual income tax returns by California registered domestic partners).

The fair market value as of the date of the decedent's death to which the trust assets are stepped up or down is determined by using the values as reported on the federal estate tax return. Treas Reg §1.1014-1(a). For both federal and state purposes, the values on the alternate valuation date are used when the alternate valuation date is used instead of the date of death. IRC §1014(a)(2). The alternate valuation date is 6 months after the date of the decedent's death, or, if an asset is sold, exchanged, or distributed before that time, the date of the disposition. IRC §2032(a); Treas Reg §20.2032-1. See Treas Reg §20.2032-1(d) for definition of "included" and "excluded." Similarly, if special use valuation was elected under IRC §2032A, the special use value is used (instead of fair market value). IRC §1014(a)(3). If no estate tax return is required, the fair market value is the appraised value for state death tax purposes. Treas Reg §1.1014-3(a). If the federal estate tax return is audited and the value of any asset was changed as a result of the audit, a corresponding change should be made to the basis records.

PRACTICE TIP: Do not assume that any time a beneficiary dies, the trust assets either obtain or do not obtain a step-up in basis. Assets of an irrevocable trust that are not taxed in a deceased beneficiary's estate do not obtain a step-up in basis on the death of the beneficiary, but assets that are taxed do. For example, a credit shelter trust of which a child is beneficiary for life, followed by child's issue for their lives, will not be taxed in child's estate and will not receive a step-up in basis on child's death. However, if the trust terms instead require outright distribution of the trust to child's issue on child's death, and child's sole issue dies after child but before distribution or sale, the assets are reportable in child's issue's taxable estate and there is a step-up in basis as of child's issue's date of death.

Assets constituting income in respect of a decedent (IRD) under IRC §691(a), *e.g.,* a promissory note held by the decedent, an annuity, IRA, or HH bonds (see IRS Letter Ruling 200336020), are not stepped up to the date-of-death value. IRC §1014(c). Proceeds of sale also may be IRD if the decedent had entered into a binding contract before death. In Rev Rul 78-32, 1978-1 Cum Bull 198, the IRS ruled that gains realized from the sale of real estate were IRD because the decedent had substantially completed all of the substantive prerequisites for consummating the sale, and therefore was unconditionally entitled to the proceeds of the sale at the time of death. In IRS Letter Ruling 200744001, however, the IRS ruled that real property subject to a sale contract on the date of death would receive a new basis, and

the proceeds of the sale would not be IRD, because the discovery of an underground gas pipeline had created "economically material contingencies" that might have disrupted the sale.

The trustee should obtain a copy of the decedent's federal estate tax return or whatever other documentation is available to ascertain the date-of-death values of the decedent's assets. On obtaining a copy of a tax return when it is not available from the decedent's records, see §7.29.

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§7.31 (3) Property Acquired by Gifts and Transfers to Trust

Property contributed to a revocable trust retains the basis that it had in the hands of the settlor. IRC §1015(b). See Drafting California Revocable Trusts §4.4 (4th ed Cal CEB 2003). Property contributed to an irrevocable trust that remains a grantor trust for federal income tax purposes (see §11.57), *e.g.*, an intentionally defective grantor trust (IDGT) or a charitable remainder annuity trust (CRAT), also retains the basis that it had in the hands of the settlor. IRC §1015(b).

All other property acquired by the trustee during the course of administration has a cost basis equal to the purchase price or fiduciary acquisition value. For a grantor trust established by spouses, the rules discussed in §7.30 apply to the extent the trust assets are includable in the estate of the first spouse to die, including any applicable step-up or step-down in basis.

If the basis, as adjusted under IRC §1016, is greater than the fair market value of the property at the time of the gift to the trust, the basis for determining loss is the fair market value of the asset. IRC §1015(a). The amount of any gift tax paid on the transfer is prorated among the assets and may increase the basis to the extent the fair market value of the property at the time of the gift exceeded the basis (*i.e.,* the amount of gift tax paid can be applied to any appreciation in value to offset gain). IRC §1015(d).

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§7.32 (4) Alternatives When Basis Information Is Unavailable

If the trustee cannot provide a basis for an asset, the Internal Revenue Service will attempt to ascertain its basis. If the IRS is unable to establish a basis, it will set the basis for tax purposes at the fair market value as of the date of acquisition by the donor, if at all possible. IRC §1015(a). The trust may suffer larger gains or reduced losses upon sale in that event. If the trust is revocable and the settlor is alive, the trustee may elect to hold the asset until the settlor's death, at which time a documented date-of-death basis will be established. If the asset must be sold during the settlor's lifetime, the trustee (or the settlor if the trust is revocable) can mitigate the capital gains by taking offsetting losses or by using a nontaxable exchange of property.

The trustee should obtain a written statement, while the settlor is alive and competent, acknowledging that basis information is unavailable if that is the fact. This will protect the trustee from future criticism for failing to obtain basis information.

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4. Record of Discretionary Actions

§7.33 a. Importance of Documenting Discretionary Actions

The attorney should advise the trustee to keep records of discretionary actions, *i.e.,* those not mandated specifically by the trust instrument. Most discretionary powers of trustees relate to investments, distributions to beneficiaries, adjustments between principal and income, and allocations of payments to income or principal. See §§2.63-2.73, 8.5.

To successfully defend an allegation of abuse of discretion, records are necessary to explain how and why such discretion was exercised. All relevant information, including notes detailing the trustee's thoughts at the time a discretionary decision was made, should be recorded. Notices of proposed action under Prob C §§16500-16504, along with proofs of service and any responses, should also be retained. On the limits of discretion, see Prob C §§16080-16081.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.34 b. Form: Record of Trustee's Discretionary Actions

§7.34 b. Form: Record of Trustee's Discretionary Actions

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RECORD OF DISCRETIONARY ACTION TAKEN _ _[*date*]_ _

1. Name of trust:

2. Date of trust instrument and amendments:

3. Power to be exercised:

a. Allowance out of income for depreciation or depletion:

b. Distribution of income:

c. Distribution of principal:

d. Adjustment between principal and income:

e. Adjustment to equalize tax benefits:

f. Unitrust conversion:

g. Other:

4. Source of power:

a. Provision of the trust instrument:

b. California Probate/Civil Code section:

c. Court order:

d. Internal Revenue Code section:

e. Revenue and Taxation Code section:

f. Other:

5. Other trust instrument provisions affecting the exercise of discretion:

6. Facts affecting the decision:

7. Recommendation of counsel:

8. Recommendation of accountant:

9. Recommendation of investment adviser:

10. Recommendations of others:

11. Decision made by trustee(s):

12. Notice of proposed action under Prob C §16500 _ _[*was served on* _ _[*name*]_ _*/was not served*]_ _**.**

Date: _ _ _ _ _ _ __[*Signature of trustee*]__
_ _[*Typed name*]_ _

Comment: This form can be modified to conform to the terms and assets of the particular trust. An attorney representing an individual trustee may give the trustee photocopies of an appropriately tailored form to be used to record all discretionary actions.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/ 5. Principal and Income Adjustments/§7.35 a. Trustee's Power and Duty to Make Principal and Income Adjustments

5. Principal and Income Adjustments

§7.35 a. Trustee's Power and Duty to Make Principal and Income Adjustments

Under Prob C §16336(a), the trustee has the power to make adjustments between principal and income, based on the nature and purpose of the trust, the intent of the settlor, the identity and circumstances of the beneficiaries, and the nature of trust assets, among other factors. The power may not be exercised under the following circumstances (see also §8.6):

- If the trustee is able to comply with the requirement to administer the trust impartially without using the adjustment power because the trustee has the power to invade principal or accumulate income (Prob C §§16335(b), 16336(a)(3));
- If income must be distributed to a surviving spouse or charitable beneficiary under the terms of a trust qualifying for an estate or gift tax marital or charitable deduction (Prob C §16336(b)(1), (b)(4));
- If the trustee is a beneficiary of the trust (Prob C §16336(b)(7)); or
- During any period in which the trust is being administered as a unitrust under Prob C §16336.4 or §16336.5 or under the terms of the trust instrument (Prob C §16336(b)(8)).

Probate Code §16361 concerning allocation of payments from "separate funds" (defined to include annuities, individual retirement accounts, and pension, profit-sharing, stock bonus, and stock ownership plans) gives the surviving spouse the right to require the trustee of a marital deduction qualifying trust (QTIP trust) to allocate to income payments received by the trust (which would otherwise be allocated 90 percent to principal) to the extent that the internal income of the separate fund exceeds payments made from the separate fund to the trust. Prob C §16361(f).

Under Prob C §16375(a), the trustee may make adjustments between principal and income to "offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries" that arise from:

- Tax elections;
- Income taxes imposed due to a distribution from a trust or estate; or
- Inclusion of distributed or undistributed taxable income of an entity, *e.g.,* IRAs, in the trust's taxable income.

The trustee must make an adjustment, decreasing income and increasing principal, or ask for reimbursement from a beneficiary if the trustee elects to deduct an amount paid from principal on an income tax return rather than the estate tax return, thereby reducing a marital or charitable deduction. The reimbursement must equal the increase in estate tax. Prob C §16375(b).

Probate Code §16374, concerning allocation of payments from a pass-through entity such as a partnership or S corporation, requires the trustee to adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to the beneficiary. Prob C §16374(d).

Under Prob C §16352(a), a trustee who conducts a business or other activity on behalf of the trust may keep separate records for its transactions, apart from the trust's general accounting records, if the trustee determines that it is in the best interest of all the beneficiaries to do so, whether or not its assets are separated from the other trust assets. Businesses for which the trustee may account separately include retail, manufacturing, service or other traditional businesses, farming, and managing rental properties. For discussion of court accounting requirements for net income or loss from a trade or business, see §7.90.

If the trustee decides to account separately, the trustee may allocate the gain or loss to principal or income. However, if the business sells assets, other than in the ordinary course of business, the proceeds must be accounted for as principal in the trust's general records to the extent that the amount is not needed to conduct the business. The trustee may also determine an amount to retain in the business for working capital or other needs. Prob C §16352(b). See §8.18.

WARNING: The amount that should be included on the "net income from a business" schedule (see §7.90) is the total

cash actually received by the trustee into the trust account. If the business shows a loss, and that loss is reflected as a net loss from a business in the accounting, there must be a distribution, or distributions, from the trust to the business that equals the loss or the accounting will not balance.

If the trustee elects not to account separately, the receipts and disbursements of the business are allocated under the regular provisions of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). See chap 8.

PRACTICE TIP: Any time the trustee needs working capital to run a business, the trustee is well advised to account separately in order to retain earnings that otherwise would be considered trust income. This is especially true if the trust requires trust income to be distributed currently.

PRACTICE TIP: If an adjustment is applicable to a given trust, it would be an excellent safeguard for the trustee, especially in trusts not subject to court jurisdiction, to give a notice of proposed action to all beneficiaries. This is in keeping with the trustee's duty to inform the beneficiaries of all actions affecting them. See §7.1.

The trustee may give a notice of proposed action (or decision not to take action) of making principal or income adjustments. Prob C §16500. A trustee who elects to give notice must mail it to all known beneficiaries who are receiving, or are entitled to receive, income or who would receive principal if the trust were terminated at the time the notice is given. Prob C §§16337, 16501(a), (c). Notice need not be given to a beneficiary who consents in writing to the proposed action or who cannot be located after reasonable diligence. Prob C §16501(b)-(c). For further discussion, see §8.9.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.36 b. Form: Notice of Proposed Action: Adjustment Between Principal and Income

§7.36 b. Form: Notice of Proposed Action: Adjustment Between Principal and Income

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_ _[*Date*]_ _
To:_ _[*name*]_ _
_ _[*address*]_ _

This notice of proposed action is being given pursuant to Probate Code §16502 by _ _[*name of trustee(s)*]_ _**, trustee(s) of the** _ _[*name of trust*]_ _ **under the** _ _[*Declaration of Trust/Trust Agreement*]_ _**dated** _ _[*date*]_ _**, whose mailing address is** _ _[*ad*dress]_ _**. You may telephone** _ _[*name*]_ _ **at** _ _[*telephone number*]_ _ **for additional information.**

Under the authority granted in Probate Code §16336, the trustee hereby states that on _ _[*date at least 45 days from the date the notice is mailed*]_ _ _ _[*he/she/it/they*]_ _ **intend to make the following adjustment(s) to income and principal. If you have an objection to the adjustment, you must provide the trustee with your written objection at the above address no later than** _ _[*date which is 45 days from the date the notice is mailed*]_ _**.**

Proposed Adjustment:

[*Describe proposed adjustment*]

The trustee has considered the following:

1. The nature, purpose, and expected duration of the trust;

2. The intent of the settlor;

3. The circumstances of the beneficiary(ies);

4. The needs for liquidity, regularity of income, and preservation and appreciation of capital;

5. The nature of the assets held in the trust;

6. The net income of the trust;

7. The increase or decrease in value of the trust;

8. The provision allowing a power to invade principal;

9. The effect of inflation and deflation and general economic conditions; and

10. The anticipated tax consequences of the adjustment.

Adjustment: _ _[*dollar amount*]_ _ **shall be allocated to** _ _[*income/principal*]_ _ **from** _ _[*principal/income*]_ _**.**

Reasons for Adjustment:

1. In keeping with the provisions of the Uniform Prudent Investor Act (see Probate Code §§16045-16054), the trustee has selected securities for their growth potential in order to produce a greater overall return than would have been achieved by investing in assets that produce greater income.

2. The value of the liquid assets of the trust at the beginning of the accounting period was _ _[*dollar amount*]**_ _. The value of the liquid assets of the trust at the end of the accounting period was _ _**[*dollar amount*]**_ _.**

3. The total return for the accounting period was _ _[*dollar amount*]**_ _ or _ _**[*percentage*]**_ _ percent.**

4. The net income of the trust for the accounting period is _ _[*dollar amount*]**_ _ or _ _**[*percentage*]**_ _ percent.**

[*If appropriate, add*]

5. _ _[*Describe other reasons dictated by the circumstances*]**_ _.**

[*Continue*]

[*If appropriate, add*]

The adjustment amount is intended to equalize the benefits from growth by allocating a portion of the growth to the income beneficiary(ies).

__[*Signature of trustee*]__
_ _[*Typed name*]_ _

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.36A c. Form: Letter to Trustee Objecting to Investment Strategy

§7.36A c. Form: Letter to Trustee Objecting to Investment Strategy

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_ _[*Date*]_ _
To: _ _[*name of trustee*]_ _
_ _[*address*]_ _

Re: _ _[*name of trust*]_ _ **Trust Account #** _ _ _ _

Dear _ _[*name*]_ _**,**

After reviewing the Trust's investment policy statement reflecting its investment strategy, along with recent account statements, we note an apparent bias to the needs of the present income beneficiary of the trust, _ _[*income beneficiary's name*]_ _**, to the detriment of the remainder beneficiaries, including my client** _ _[*remainder beneficiary's name*]_ _**.**

As trustee, you must maintain impartiality toward all beneficiaries, present and remainder, income and principal. On behalf of my client I therefore request that your investment policy be corrected to reflect this impartiality and that the assets in the trust be balanced between income and growth.

It is my understanding that _ _[*e.g., the "efficient frontier" (60 percent stocks and 40 percent bonds)*]_ _ **is the accepted investment strategy that best reflects impartiality toward the interests of all beneficiaries.**

Thank you for your prompt attention to this matter.

Very truly yours,

__[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

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§7.37 6. Documenting Compliance With Uniform Prudent Investor Act

The trustee should keep documents showing that, to comply with the requirements of the Uniform Prudent Investor Act (UPIA) (Prob C §§16002(a), 16003, 16045-16054), the trustee has considered, either alone or with an investment manager or advisor, the following:

- Investment policy statement (IPS). All IPSs should be retained, along with any documentation of any changes to the investment policy, and the reasons for the changes.
- Investment management delegation. Retain the documentation delegating the management decisions to others in the permanent records of the trust along with correspondence from the manager regarding reasons for investment changes.
- Investment reviews. A review might consist of a formal review completed by an investment manager or might be of a less formal nature, consisting of the trustee's notations of when the assets were reviewed and what decisions the trustee made and on what basis.

PRACTICE TIP: Even though a beneficiary might have no voice in the investment decisions, it is prudent to inform him or her before changes are made. If there is an adverse reaction, *e.g.,* the beneficiary dislikes a particular stock, at least in some situations another option might be chosen that is just as suitable. The information about the proposed change can be set forth in a letter to the beneficiary(ies) that accompanies an account. The beneficiary will then have sufficient information to review the proposed changes and respond. The letter can state that the trustee intends to take the action(s) on a particular date, far enough in advance for the beneficiary to respond. Beneficiaries who know that their views have been considered are less likely to contemplate lawsuits.

When representing a beneficiary, counsel should obtain and review the UPIA documentation and the trust accounts with a view to whether the trust investments are consistent with the trust's investment policy statement and whether they reflect impartial treatment of all trust beneficiaries (income and remainder). For a form of letter to the trustee objecting to investment strategy, see §7.36A.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.37A 7. Tax Treatment Information

§7.37A 7. Tax Treatment Information

Documentation of tax exemption, allocations, or elections for the trust should be retained. This includes, *e.g.,* Schedule R of the estate tax return (IRS Form 706) or a gift tax return (IRS Form 709) allocating a generation-skipping transfer (GST) tax exemption to the trust, and any opinion letter regarding automatic allocation of unused GST tax exemption under IRC §2632(e)(1).

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§7.38 8. Miscellaneous Administrative Records

The trustee should retain copies of all correspondence pertaining to the trust, including letters and notes; memorandums of telephone conversations, meetings, and trust business conferences; and summaries of oral communications with accountants, attorneys, or other parties regarding trust assets.

The trustee should keep time records relating to trust business, *e.g.,* "30 minutes in valuing assets, 1 hour talking to beneficiary," to support claims for trustee compensation. For discussion of factors determining amount of trustee compensation, corporate fee schedules, and court fee guidelines for some administrative functions of trustees of supervised trusts, see chap 9.

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D. Recordkeeping Involving Multiple Interests

§7.39 1. One Trust, Separate Shares

If there are several beneficiaries of one trust, or if the trust instrument provides that the assets for several separate shares of one trust may be handled as one fund, accounts to the beneficiaries may be accomplished with one set of records clearly distinguishing each beneficiary's interest. However, tax records for each beneficiary should be kept individually. See chap 11.

This same principle will apply to a trust that contains both community property and separate property of the settlors inasmuch as accounting for the separate property will need to be kept separately from the community property assets. Similarly, an accounting for an administrative trust should distinguish between transactions pertaining to the surviving spouse personally and those of the administrative trust estate. See §14.19.

NOTE: Some trust interests should never be combined in the same trust and treated merely as a separate share in the accounting, *e.g.*, QTIP property (see §§12.26, 12.45, 14.28), GST-exempt property (see §§12.56, 14.45), and QFOBI property (see §12.25). Instead, separate trusts should be created if permitted by the trust instrument. See also §14.81.

If the trust has more than one beneficiary, discretionary payments are commonly charged to the share of the beneficiary receiving the payment. If this affects only the ultimate distribution of the corpus at the termination of the trust, recordkeeping is relatively simple.

PRACTICE TIP: Problems arise when the trust instrument requires an immediate reduction in the principal share of a beneficiary and income distributions are based on principal shares, because such a reduction will reduce the amount of income later paid to the beneficiary. In such a case, it might be wise to split the trust into separate shares at the time of the first distribution for ease of recordkeeping. This is particularly true if the trust might have more than one trustee over the course of its duration and the accounting method or software used does not allow for tracking distributions, or if the trustee anticipates that there will be many requests for distributions over the life of the trust. Creating separate shares with separate recordkeeping for each beneficiary avoids the problem of over-distributing corpus at the termination of the trust to the recipient of the discretionary distributions and then trying to recover the excess.

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§7.40 2. One Instrument, Separate Trusts

Separate trusts created under the same trust instrument require separate sets of records for each trust, which makes it possible to account properly to beneficiaries, the court (if applicable), and taxing authorities. If several trusts have undivided interests in the same asset, the receipts and disbursements relating to the asset should be allocated and recorded according to the amount of the interest. For example, if two trusts each own a one-half undivided interest in a piece of income-producing real property, entries recording the receipt for each might read: "one-half rent due 11/29/06 on 123 Main Street," or "one-half real estate taxes due 4/10/06 on 123 Main Street" with the appropriate dollar amounts.

PRACTICE TIP: Property that should always be held in a separate trust and accounted for separately includes QTIP property (see §§12.26 and 12.45) and GST-exempt property (see §12.56). This is particularly important for GST-exempt property, so that the GST exemption is not lost as to the future appreciation of the assets in the GST-exempt trust.

It is possible, when multiple trusts have interests in the same asset, to create one central account or ledger to handle all receipts and disbursements for that particular asset. Then, only net credits or debits need be reflected in each individual trust's records. Copies of the accounting from this ledger can be provided to beneficiaries or the court, along with any other accounting, to show all the detailed entries. This type of account can substantially simplify the trustee's recordkeeping.

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§7.41 E. Receipts and Disbursements

Records of receipts and disbursements must always be itemized. It is not sufficient, for example, for a trustee to record a bank deposit simply as "dividends." The trustee should list separately each dividend in each deposit, identifying the security that paid it and the date it was received. Without this detail, the trustee or accountant has no way of monitoring the relative performance of particular assets or verifying that all dividends or other distributions have been received. Dividend and interest entries can be checked against income tax Forms 1099 received from dividend and interest payors annually. For receipts in court accounts, see §§7.83-7.89.

PRACTICE TIP: When accounting for an administrative trust following the death of a married settlor, if that approach is chosen (see §§14.2-14.6), the trustee should make the record clear as to which transactions pertain to the surviving spouse personally and which pertain to the administrative trust estate. See §§14.19-14.25.

Disbursement entries should state the payee's name and the services or products for which payment was made. Such information is necessary for a court account. See §§7.94-7.95.

PRACTICE TIP: Receipts and disbursements may be listed by category or by date. The first is preferable and should always be used if the records are being kept on a computer.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.42 1. Allocation of Receipts and Disbursements to Principal and Income

§7.42 1. Allocation of Receipts and Disbursements to Principal and Income

When a trust has both income and remainder beneficiaries, all receipts and disbursements must be recorded as either principal or income transactions, to correlate with the differing interests and differing rights of the income and remainder beneficiaries. Absent any directions in the trust instrument to the contrary, the allocations to income and principal should comply with the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). Prob C §16335(a)(3). If there are, however, provisions in the trust instrument directing allocations to principal or income, they must be followed; the instrument controls over provisions of the act. Prob C §16335(a)(1). If a trustee has discretion regarding those allocations, the trustee's decision is controlling. Prob C §16335(a)(2).

PRACTICE TIP: Be sure to read the terms of the trust.

The table in §7.43 shows how funds received and paid out by the trust must be allocated under the UPAIA. The default provision for allocation is found in Prob C §16335(a)(4), which states that the trustee "[s]hall add a receipt or charge a disbursement to principal to the extent that the trust or the will and this chapter do not provide a rule for allocating the receipt or disbursement to or between principal and income." Special rules require allocation to income of payments received by marital deduction qualifying trusts (QTIP trusts) from annuities, individual retirement accounts, and other retirement or stock plans to the extent of the internal income of the separate fund under Prob C §16361. See §8.24.

PRACTICE TIP: One problem area is the allocation of shares of stock received under a dividend reinvestment plan. Under Prob C §16350(c), money received from an entity is allocated to income, while property other than money is allocated to principal. See §8.16. Under one analysis, the company is paying a cash dividend combined with providing a service to shareholders to easily purchase additional shares in an amount equal to the dividend paid. Under this analysis, the trustee would report the dividend dollar amount as a receipt of money with a concurrent conversion of money into shares (see §7.104). Under an alternative analysis, what the trust actually receives is shares of stock—not money—and the receipt of shares should be treated as principal. However the trustee accounts for the shares, it should be done consistently, and receipts from any marital deduction assets (*e.g.,* in a QTIP trust) should be accounted for consistent with marital deduction requirements. See Treas Reg §20.2056(b)-5(f)(3) (rules provided for allocation to income of such receipts as ordinary cash dividends must give the spouse substantial enjoyment of trust assets).

Proper allocation is a particularly complex task if receipts consist of payments other than dividends and interest or if depletion or depreciation must be accounted for. Under Prob C §16373, transfers from income to principal to build a reserve are allowed for:

- Unusually large amounts chargeable to income, including extraordinary repairs;
- Capital improvements, including special assessments;
- Expenses incurred in preparing for rental;
- Depreciation reserve, providing that the transfer amount is less than period payments made on an obligation secured by the asset;
- Environmental costs allocated to principal under Prob C §16371(a)(7).

Tax consequences may depend on whether funds received and expenditures made are attributable or chargeable to principal or income. If a trust distributes income to a beneficiary, the account must allocate receipts and disbursements between (1) principal receipts and disbursements and (2) income receipts and disbursements. Cal Rules of Ct 7.901(c).

NOTE: It is unclear how receipts and disbursements are allocated during a period in which the trust is being administered as a unitrust under Prob C §16328. See §8.15A. However, the logic of a unitrust would appear to preclude the application of other allocation rules. The unitrust amount is a net amount; expenses that would otherwise be charged to income may not be deducted from the unitrust amount. Prob C §16336.4(e)(8).

For further discussion of proper allocation, see chap 8.

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§7.42A 2. Practical Difficulties in Allocating Expenditures to Principal

Practical difficulties arise in allocating expenditures to principal for trusts with illiquid principal assets. For example, in a net income trust in which the sole asset is an apartment building, all of the rents received are considered income and many of the expenses incurred are attributable, at least in part, to principal. In a simple hypothetical, the trust may receive $100,000 in rental income during the year and (ignoring all other operating expenses) incur $10,000 in legal, accounting, and trustee fees. All of these expenses are attributable one-half to principal and one-half to income. The $5000 in fees chargeable to income is easily paid for. However, there are no liquid assets from which to pay the share of the expenses chargeable to principal. The income beneficiary is expecting a check for $95,000, but there is only $90,000 left in the account after the expenses are paid.

At first glance, the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) does not seem to provide an easy remedy to this dilemma. Probate Code §§16372-16374 provide for the transfer of income to principal under very limited circumstances that do not fit the above scenario. Under Prob C §16336(a), the trustee may be able to convert trust income to principal to pay the principal expenditures. However, to do so, the trustee must first make a determination under Prob C §16335 that to do so would not improperly favor the principal beneficiaries. As a practical matter, converting income to principal for the purpose of paying expenditures normally attributed to principal is tantamount to charging all expenses to income. The trustee may be loath to do so without substantial justification.

One solution to this dilemma would be to account separately for the apartment building and retain a portion of the earnings as working capital. Although this is authorized by Prob C §16352(a) and (b), one wonders, as a practical matter, how this is any different from simply charging all of the expenses to income. See §8.18. Furthermore, payment of legal, accounting, and administrative expenses of the trust probably does not qualify as "working capital." The better solution would be for the trustee to sell the apartment building and invest in both liquid and illiquid assets (such as real property and a money market fund) or borrow against the apartment building to generate a fund for paying principal expenditures.

A trustee caught off guard in this situation may feel the need to temporarily "borrow" a portion of the income of the trust to make timely payments of expenditures chargeable to principal. If this is done, presumably interest should be paid to the income beneficiary. The question of how much interest then arises. Clearly, a liquidity analysis should be done by the trustee before or immediately following acceptance of the office of trustee in order to better plan for this situation.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.43 3. Table: Allocating Receipts and Disbursements Under the California Uniform Principal and Income Act (UPAIA) During Administration of Trust

§7.43 3. Table: Allocating Receipts and Disbursements Under the California Uniform Principal and Income Act (UPAIA) During Administration of Trust

▶ To download **Word** version, right click and choose *Save Target As*

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Description	*Probate Code Section*	*Principal*	*Income*
RECEIPTS			
Note: See Prob C §§16336 and 16365(a) for discretionary adjustments and Prob C §16361(f) for adjustments that may be requested by the surviving spouse; see also §§8.4-8.8.			
Entities:			
Money, unless otherwise provided below (see §7.42)	16350(b)		100%
Property other than money (see §7.42)	16350(c)(1)	100%	
Money received for interest in entity, including full liquidation	16350(c)(2)-(3)	100%	
Money received on partial liquidation, as defined (see §7.83)	16350(c)(3), (d)-(e)	Balance	Amount of income tax
Sale or exchange proceeds, including capital gains	16355(b), 16365(b)	100%	
Capital gain dividends from RIC or REIT	16350(b)(4)	100%	
Dividends accrued before administration	16346(a)	100%	
Dividends accrued during administration (see §7.42)	16346(b)		100%
Interest	16357		100%
Debt instruments:			
Interest accrued during administration	16346(b), 16357(a)		100%
Amount received as consideration for prepaying principal	16357(a)		100%
On obligations maturing after 1 year, sales amount received including premium over value (see §8.21)	16357(b)	100%	

On obligations maturing within 1 year, difference between cost and maturity (see §8.21)	16357(b)		100%
Interest accrued before administration (see §8.14)	16346(a)	100%	
Derivatives:			
Rights (see §8.29)	16366(b)	100%	
Options (see §8.29)	16366(c)	100%	
Asset-backed securities:			
Note: If the allocation between income and principal under §16367 is insubstantial, all may be allocated to principal. Prob C §16360.			
Payment from interest, current return, or other (see §8.30)	16367(b)	Balance	Portion identified as interest or current return
Payment in exchange for entire interest in security	16367(c)	100%	
Payment that is one of series of payments resulting in liquidation of trust's interest	16367(c)	90%	10%
Payments from "separate fund" (annuities, or retirement or stock plans):			
Note: If the allocation between income and principal under §16361 is insubstantial, all may be allocated to principal. Prob C §16360.			
Payments to marital deduction qualifying trust (QTIP trust) other than payments from qualified survivor annuities if trust would not qualify under §16361(b)-(c):	16361(d) 16361(e)		
If documentation from payor reflects internal income of separate fund	16361(f)	Balance	Amount of internal income
If no documentation from payor reflects internal income of separate fund	16361(g)		4% of fund value; or product of interest rate and present value of future payments per IRC §7520
Payments not to marital	16361(a)		

deduction qualifying trust from separate fund and all other payments:			
Portion of payment characterized as interest or dividends, or in lieu thereof	16361(b)	Balance	100% of such portion
No part of payment characterized as interest or dividend or equivalent payment:			
When all or part of payment is required to be made	16361(c)	90%	10%
When no part of payment is required to be made	16361(c)	100%	
When payment is entire amount to which trustee is entitled	16361(c)	100%	
Minerals, water, and natural resources interests:			
Note: If the allocation between income and principal under §16363 is insubstantial, all may be allocated to principal. Prob C §16360.			
Nominal rental (see §8.26)	16363(a)(1)		100%
Production payment (if factor for interest)	16363(a)(2)	Balance	Interest amount
Production payment (no factor for interest)	16363(a)(2)	100%	
Royalty (more than nominal)	16363(a)(3)	90%	10%
Other mineral payment	16363(a)(4)	90%	10%
Payment for renewable water interest	16363(b)		100%
Payment for nonrenewable water interest	16363(b)	90%	10%
Timber:			
Note: If the allocation between income and principal under §16364 is insubstantial, all may be allocated to principal. Prob C §16360.			
Payments for renewable timber if beneficiary has a mandatory income interest; or lease (see §8.27)	16364(a)(1), (a)(3)		100%
Payments for timber exceeding growth rate; or lease	16364(a)(2), (a)(3)	100%	
Net receipts from sale of standing timber	16364(a)(2)	100%	

Other advance payments	16364(a)(4)	100%	
Deduction of a reasonable amount for depletion	16364(b)	Add amount	Subtract amount
Real estate (not accounted for separately as a business under Prob C §16352):			
Rents (see §8.20)	16356		100%
Amount received for cancellation of lease	16356		100%
Amount received for renewal of lease	16356		100%
Rental deposits	16356	100%	
Sale or exchange proceeds, including capital gains	16355(b), 16365(b)	100%	
Eminent domain proceeds in general (see §8.19)	16355(d)	100%	
Eminent domain—separate award for loss of income if a beneficiary has a mandatory income interest	16355(d)		100%
Insurance policies:			
Dividends if premiums paid from principal (see §8.22)	16358(a)	100%	
Dividends if premiums paid from income	16358(a)		100%
Proceeds of insurance policy in general	16358(a)	100%	
Proceeds insuring loss of income (see §8.22)	16358(b)		100%
Proceeds insuring loss of profits from business if not accounted for separately under §16352	16358(b)		100%
Proceeds insuring loss of occupancy or use by income beneficiary	16358(b)		100%
Receipt from trust or estate:			
Distribution of income	16351		100%
Distribution of principal	16351	100%	
Other receipts:			
Sales, exchange, or liquidation proceeds, including capital gains	16355(b), 16365(b)	100%	
Reimbursement not based on lost income	16355(c)	100%	
Net income if there is no income beneficiary	16355(e)	100%	

Receipts from liquidating assets (if no reserve for depreciation) (*e.g.,* leasehold, patent, royalty right, copyright)	16362	90%	10%
Note: If the allocation between income and principal under §16362 is insubstantial, all may be allocated to principal. Prob C §16360.			
DISBURSEMENTS			
Administration expenses:			
Note: See Prob C §16336 and §§8.4-8.8 for discretionary adjustments; Prob C §16340 re disbursements after decedent's death or income interest in trust ends (see also Prob C §16373(c)); Prob C §16372 re transfers from income to principal for depreciation; and Prob C §16373 re transfers from income to principal to reimburse principal disbursement or future interest			
Trustee fees (regular compensation)	16370(a), 16371(a)(1)	50%	50%
Trustee fee calculated on principal for acceptance, distribution, or termination, and disbursements made to prepare property for sale	16371(a)(2)	100%	
Investment advisor fees	16370(a), 16371(a)(1)	50%	50%
Custody fees	16370(a), 16371(a)(1)	50%	50%
Accounting fees	16370(b), 16371(a)(1)	50%	50%
Judicial proceedings involving both income and remainder interests	16370(b), 16371(a)(1)	50%	50%
Judicial proceedings construing or protecting trust and trust property	16371(a)(4)	100%	
Judicial proceeding concerning primarily principal	16371(a)(4)	100%	
Judicial proceedings concerning primarily income	16370(c)		100%
Ordinary expenses re administration, management, or preservation of trust property	16370(c)		100%
Taxes:			

Tax on ordinary income	16374(a)		100%
Tax on trust's share of entity's taxable income:			
To extent receipts from entity are allocable only to income	16374(c)(1)		100%
To extent receipts from entity are allocable only to principal	16374(c)(2)	100%	
To extent receipts from entity are allocated to both principal and income	16374(c)(3)	Balance	Proportion allocated to income
To extent tax paid exceeds total receipts from entity	16374(c)(4)	100%	
Note: Principal and income receipts adjusted to the extent taxes reduced because trust receives tax deduction (*i.e.,* none for electing small business trust) for payment made to beneficiary. Prob C §16374(d). See §8.35.			
Tax on capital gains	16374(b)	100%	
Estate, transfer taxes and penalties	16371(a)(6)	100%	
Property taxes; regularly recurring taxes assessed against principal	16370(c)		100%
Real-estate-related expenses:			
Management expenses	16370(c)		100%
Disbursements to prepare property for sale	16371(a)(2)	100%	
Ordinary repairs	16370(c)		100%
Principal portion of mortgage payments	16371(a)(3)	100%	
Interest portion of mortgage payments	16370(c)		100%
Casualty insurance premiums	16370(d)		100%
Contamination-related expenses and legal fees	16371(a)(7)	100%	
Trust Debts:			
Payments on principal of a trust debt	16371(a)(3)	100%	
Payments of interest on a trust debt	16370(c)		100%
Note: If principal asset is encumbered with obligation requiring income to be paid to creditor, see Prob C §16371(b) re transfer of funds from			

principal to income			
Other expenses:			
Premiums on insurance policies covering loss or a principal asset or loss of income from asset	16370(d)		100%
Premiums on insurance policies other than loss if trust is owner and beneficiary	16371(a)(5)	100%	

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§7.44 4. Receipts and Disbursements Ledger

In the absence of computerized records (see §7.45), properly maintained ledgers will substitute. They will supply information for many purposes. They eliminate the need for repetitious review and reworking of financial data. The record of cash receipts and disbursements supplies information for accounting and for income tax returns. Balances in trust bank accounts can be reconciled from these records. The trust's cash flow and the productivity of particular assets are easily determined.

It is best to update the ledger whenever there is any accounting activity, such as deposits or disbursements. Doing so reduces the possibility of omitting a deposit and simplifies the verification of bank statements. Deposits to interest-bearing accounts should be channeled through one checking account. That is, if proceeds of a sale of assets are to be deposited into an interest-bearing account, they should first be deposited into a checking account and then withdrawn for deposit to the interest-bearing account. The checking account then becomes the principal record for the trust's financial transactions, and the amount on hand can be verified by the balances in both checking and interest-bearing accounts.

The number of ledger columns and the categories will depend on the character and volume of the trust receipts. Each column should contain information useful for some specific administrative purpose, *e.g.,* information relating to accounting and tax returns is signaled to the trustee under "sale of assets" and "dividends."

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§7.45 5. Computerized Recordkeeping

In choosing a computer program for preparing accountings, consider (1) who is going to write the checks and make the deposits and (2) whether the accountings will be sent only to the beneficiary or will also be presented to the court. If the trustee is writing the checks and making the deposits, and is using a software program for personal money management (*e.g.,* Quicken or Microsoft Money), it is inefficient to have the data entered twice, *i.e.,* for trustee's records and accountant's records. If the accountings are sent directly to beneficiaries, it is possible to customize the standard financial management programs to prepare the schedules needed to attach to a Summary of Account (done on a word processing program) directly from the data entered into the personal money management program. These schedules do not lend themselves well to much customizing.

PRACTICE TIP: If the trust assets include few securities, Quickbooks is useful because it can be customized to a greater extent than Quicken and can be used to produce a court account in the required format. If the trust has many investments and there is no investment manager, or the investment management company does not use its own custodial account, Quicken is the better choice because it has features for investment tracking and will produce reports helpful for investment management.

If the accounting is a court accounting, or if the account preparer desires more flexibility, the data from the trustee's software can be downloaded into a spreadsheet program and the data manipulated to conform to a standard court accounting format.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.46 a. Online Banking

§7.46 a. Online Banking

Online banking consists of two separate and distinct components: (1) sending payments using a computer program and (2) updating trust financial records by downloading the information into the computer program directly from the financial institution. The components can be used together or separately. The services are inexpensive, often free. Some Internet service providers offer online banking.

NOTE: Some financial institutions do not allow online banking services for some types of fiduciary accounts.

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§7.47 (1) Downloading Information From Banks and Brokerages

Most banks and some brokerage houses allow the customer to download dividends, interest, and payment records directly into the account holder's financial management program, *e.g.,* Quicken or Microsoft Money. Indeed, some financial institutions will give the depositor the necessary software. This service both eliminates the need for most data entry and facilitates reconciliation of bank and brokerage statements. In addition, most programs have a feature that allows the user to automatically update market values as of a particular date if the information is requested in a timely manner.

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§7.48 (2) Automated Checking

Checks may be sent by recording them in the software program on the computer and sending the data via a modem to the financial institution, either a bank or a brokerage, or through a service used by the financial institution. The institution will either wire the funds or mail a check to the intended recipient. All disbursements are recorded as checks that can be cashed without a signature. If the trustee desires, canceled checks can be returned with the monthly statement, usually at an additional charge. Alternatively, the trustee can request that copies of all checks be attached to the statement.

PRACTICE TIP: There are many security issues, some of which can be handled with appropriate safeguards. It is possible to set up accounts at brokerage houses that allow automatic transfers in a specified amount to accounts in other financial institutions. All acting trustees must sign the form to establish this feature for the account. The receiving account could be an operating account for the trustee who is the responsible for paying routine bills. Most computer programs allow at least two levels of passwords, one to open the check register for data entry or to download information from financial institutions, which is useful if the trustee or agent has employees, and a second to send payment instructions to the financial institution.

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§7.49 b. Fiduciary Accounting and Spreadsheet Programs

Software packages that automate the preparation of fiduciary accountings are available. Some examples include Probate Plus and FATE (Fiduciary Accounting for Trusts and Estates). The trustee should ask for a sample of the accounting format produced by the program.

PRACTICE TIP: Many accounting programs, however, treat liabilities as an integral part of the accounting, contrary to the statutory requirements for California trust accounts.

Most spreadsheet programs, *e.g.,* Lotus and Excel, allow the user to transfer data from a financial management program, *e.g.,* Microsoft Money, Quicken, or Quickbooks, without reentering the data. Another advantage of a spreadsheet program is that the schedules needed for an accounting can be formatted to comply with those acceptable to a court. This ability to customize is especially useful when the accounting is for a net income trust, *i.e.,* one that requires a separation of principal and income, because packaged financial management programs do not have the capacity to add columns to a receipts or disbursements schedule.

See §7.126 for explanation of spreadsheet forms on the disk that accompanies this book.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.50 F. Tax Preparation Considerations

§7.50 F. Tax Preparation Considerations

A trustee is responsible for preparing and filing the income tax returns for the trust. If there is no probate estate, the trustee may also be responsible for filing any estate tax returns due. See chap 12. The trustee should keep a separate folder for the information about income and deductions that will be needed by the income tax return preparer, along with information about the bills paid in connection with administration of the estate of the deceased trustor(s). The tax information folder should also include a list of assets with date-of-death values and any confirmations of sales of assets.

NOTE: Some fiduciary accounting programs are designed to be compatible with estate and income tax preparation programs.

If the recordkeeper uses a computer, all entries should be categorized to facilitate the preparation of schedules for accounting and tax returns. If the person preparing the accounting is using a software program to prepare a tax return, the categories should be identified as taxable, nontaxable, and so forth, so that they appear on the appropriate schedules in the return. If someone else is to prepare the return, data should be similarly designated. Some financial management programs can mark an entry so that it will appear on the correct schedule in the accounting.

If the assets are received from a former fiduciary, the two fiduciaries should decide which one will declare the income received or the deductible items paid during the period between the end of the accounting showing the distribution of assets by the former trustee and the time the assets were received by the new trustee.

If the assets are from an estate or a revocable trust, the new trustee should consider recording the beginning assets on a principal receipts schedule, showing the date of receipt. This approach makes it easier to prepare income tax returns, because the income shown on the accounting will correspond with the appropriate tax identification number.

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§7.51 G. Records Subject to the Attorney-Client Privilege

In *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317, the California Supreme Court held that the successor trustee assumes all the powers of the office of trustee, including the power to assert the attorney-client privilege for confidential communications on the subject of trust administration. See also *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 91 CR2d 716, distinguishing and explaining *Moeller.* When an attorney is asked by the trustee for counsel regarding a matter and the attorney has reason to believe that the trustee might want the communication to be privileged, the attorney should advise the trustee client of the holding in *Moeller* and suggest that either the trustee seek advice from another attorney or, alternatively, that the attorney fee be paid out of the trustee's personal funds. See also *Eddy v Fields* (2004) 121 CA4th 1543, 18 CR3d 487 (without reaching apparent conflict posed by statutory work product privilege and client's right to his or her file, court held that if work product privilege was waived by attorney with respect to predecessor trustee, it was also waived as to successor trustee).

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§7.52 H. Retention and Disposition of Records

Because the trustee's duty to account remains in effect for the life of the trust (*Knapp v Knapp* (1940) 15 C2d 237, 241, 100 P2d 759), the trustee's attorney should advise the trustee to retain all records for at least 4 years after the trust terminates, or until the expiration of the statute of limitations for litigation against the trustee. Problems or questions can arise years after a disputed event has occurred, and without records the trustee could not reconstruct the causes that justified certain administrative actions. Taxing authorities, as well as beneficiaries who were minors at the time of a particular event, may raise questions about the propriety of an action taken. Certain trust records should be kept forever. If all beneficiaries are ascertainable and all have received accountings (either court accountings or accountings that meet the requirements set forth in §7.60), routine records, particularly those that can be obtained elsewhere, may be destroyed. For discussion of the statute of limitations for actions disclosed in an accounting, see §7.64A.

An individual trustee, with little available space, should retain all records that cannot be obtained elsewhere (*e.g.,* copies of correspondence between the trustee and other parties and all records pertaining to actions not fully disclosed, in an accounting or otherwise, to the beneficiaries). Petitions or accountings on file with the court need not be saved because they are available from the county clerk's office or from court archives.

Corporate trustees retain all written records and microfilm or microfiche of computerized transactions either indefinitely or for many years after the trust has ended.

If space is at a premium and if a court accounting has been filed, records can be destroyed 180 days after the court order is issued approving the accounting, provided that no appeal is filed. See §7.124. If beneficiaries have received informal accountings with the appropriate notice (see §7.65), records can be destroyed 3 years from the time the accounting was mailed.

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III. ACCOUNTING TO BENEFICIARIES

§7.53 A. Accounting Requirements

The general duty of a trustee "to keep the beneficiaries of the trust reasonably informed of the trust and its administration" under Prob C §16060 is separate from the duty to account under Prob C §§16061 and 16062, and is not subject to waiver in the trust instrument under Prob C §16064. This part discusses the specific accounting requirements of Prob C §§16061 and 16062, and only occasionally touches on the requirements of Prob C §16060, which is a much more fluid and undefined, and potentially broader, standard than that of those specific accounting requirements. See §7.1. Persons entitled to accounts are governed by Prob C §16062. See §§7.54-7.54C. On who should prepare the account, see §§7.55-7.55C. On when to account, see §§7.56-7.56B. On waiver of accounting, see §§7.57-7.59. The contents of an account to a beneficiary are governed by Prob C §16063. See §§7.60-7.64. On liability protection for the trustee when the account is made, see §§7.64A-7.65. On advantages of a court account versus a noncourt account, see §§7.65A-7.65G.

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§7.54 B. To Whom to Account

The trustee must account "to each beneficiary to whom income or principal is required or authorized in the trustee's discretion to be currently distributed." Prob C §16062(a). This would include, for instance, each member of a group eligible to receive sprinkling distributions of income, or principal invasions, whether or not he or she received any amount from the trust during the accounting period or at any other time. Although not generally required, the trustee may wish to provide accounts to contingent and remainder beneficiaries (see §7.54A) or beneficiaries of a revocable trust (see §7.54B) and accounts for trustee actions in a nonfiduciary capacity (see §7.54C). For a list of Probate Code provisions describing trust beneficiaries, see chart in §15.21A.

NOTE: Names and addresses obtained from the settlor at the inception of the trust should be verified periodically, *e.g.*, once a year, and on the death of a settlor or whenever an amendment is made that could change the beneficial interests. Because Prob C §24 includes future and contingent interests in its definition of "beneficiary," the attorney should consider withdrawal rights and powers of appointment given in the trust instrument when reviewing the chart in §15.21A.

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§7.54A 1. Accounting to Contingent and Remainder Beneficiaries

In addition to the requirement to account to current beneficiaries (including discretionary beneficiaries) under Prob C §16062(a), the trustee may be required or may choose to account to contingent and remainder beneficiaries, taking into account withdrawal rights and powers of appointment given in the trust instrument. See also §7.118. Upon reasonable request of a beneficiary (including a remainder beneficiary), the trustee is required to provide "a report of information about the assets, liabilities, receipts, and disbursements of the trust, the acts of the trustee, and the particulars relating to the administration of the trust relevant to the beneficiary's interest." Prob C §16061. See also Restatement (Third) of Trusts §§82(2), 83 (2007). In *Esslinger v Cummins* (2006) 144 CA4th 517, 50 CR3d 538, the court affirmed the trial court's order of a "particular account" under Prob C §16061 to a remainder beneficiary who was not entitled to an account under Prob C §16062. The trustee also has a general duty under Prob C §16060 to keep all beneficiaries, including contingent and remainder beneficiaries, reasonably informed of the trust and its administration. The trustee has a duty to communicate the information reasonably necessary to enable contingent remainder beneficiaries to enforce their rights under the trust or to prevent or redress a breach of trust. *Salter v Lerner* (2009) 176 CA4th 1184, 99 CR3d 1. See §7.1.

PRACTICE TIP: Because the 3-year statute of limitations in Prob C §16460 (see §7.64A) and the 180-day limitations period for filing objections in Prob C §16461 (see §7.65) are effective only as to beneficiaries who actually receive the account, the attorney should consider including contingent and remainder beneficiaries in the account and in the notice of a court proceeding to approve the account. See discussion in §§7.65A-7.65G.

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§7.54B 2. Accounting to Beneficiaries of Revocable Trust

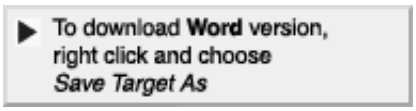
The term "beneficiary" as used in this context excludes all beneficiaries of a revocable trust unless the beneficiary holds the power to revoke. Prob C §§15800, 16064(b). If the holder of a power to revoke is competent, the power holder is treated as the sole beneficiary of the trust for accounting purposes and the trustee need not account to other beneficiaries. *Johnson v Tate* (1989) 215 CA3d 1282, 264 CR 68. The trustee does not violate the duty to account by not advising contingent beneficiaries of the existence or status of a revocable trust. Prob C §§15800, 16064(b).

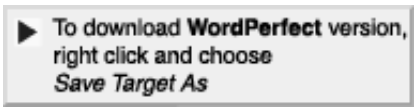
One court has held that a beneficiary of a revocable trust was not entitled to information and accounts despite the settlor's incompetence because the settlor's conservator still had the power to revoke the trust under the Prob C §2580 substituted judgment statute even though the conservator had not been granted the power of revocation. *Johnson v Kotyck* (1999) 76 CA4th 83, 90 CR2d 99. In *Evangelho v Presoto* (1998) 67 CA4th 615, 79 CR2d 146, the court concluded that, under the specific circumstances of the case, the beneficiaries made the necessary showing for requiring an accounting of the trust over the *entire* period of the trust by the trustee who served as trustee before the settlor's death (when the trust was still revocable). When the trustee and the beneficiary are the same person, there is no duty to account. Prob C §16064(d).

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.54C 3. Accounting for Trustee Actions in Nonfiduciary Capacity

§7.54C 3. Accounting for Trustee Actions in Nonfiduciary Capacity





Extra caution and additional accounts may be advisable for actions a trustee performed in a nonfiduciary capacity, but which a disgruntled beneficiary may construe as actions in the capacity as trustee in an attempt to obtain probate court jurisdiction. In such a situation, the trustee might consider providing an account with notices limiting the time for filing objections or claims under Prob C §§16063 and 16461 (see §§7.64A-7.65) and stating that such notices apply insofar as the actions taken could be construed to be actions as trustee. The purpose is to cut off this avenue of potential claim by a beneficiary. For example, the notices could be prefaced with the following language.

The account of _ _[*name of trustee*]_ _ as _ _[*e.g., agent for* _ _[*name*]_ _]_ _ is set forth herein. To the extent that _ _[*name of trustee*]_ _'s actions may be construed as actions by the Trustee of the _ _[*name*]_ _ Trust, Trustee provides the following notice:

Such actions may include the following:

- The person who is now the trustee may have taken actions as agent under a power of attorney before the principal's death (*e.g.,* the principal is also the settlor of the trust or a former trustee);
- There is a pourover will and no appointed personal representative, and the trustee has had to take significant actions to secure the assets for the trust, or has decided to abandon worthless assets and has not received them in trust; and
- The trustee may have taken actions as the general partner of the limited partnership (or manager of an LLC) in which the trust owns a limited partnership (or LLC membership) interest.

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§7.55 C. Who Should Prepare the Account

It is the trustee's duty to prepare the accounting, and the trustee may perform this duty personally (see §7.55A). Prob C §16062(a). However, as a practical matter, this duty may be delegated to the attorney (see §7.55B) or to an accountant or other agent (see §7.55C), subject to the trustee's duty to exercise general supervision over the person performing the accounting. Prob C §16012(b).

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§7.55A 1. Trustee Prepares Account

If the trustee is receiving a fee based on a percentage of market value of the assets in the trust, and the trustee prepares the accounting, the expense of presenting an accounting is borne by the trustee from the trustee's fee. If the trustee has a computer and the accounting is informal (*i.e.,* not under court supervision), the trustee can send reports generated by the computer program directly to the beneficiaries, *i.e.*, the accounting does not have to be in the same format as one required by the court. If the trustee has a computer but is unable to prepare the accounting because the accounting is complex, or receipts and disbursements need to be allocated to principal or income, or the accounting must be in the format for a court accounting, the attorney may suggest that the trustee send the relevant information on a disk to someone with the requisite knowledge to prepare the accounting. It is fairly easy to transfer the data from financial management software such as Quicken or Microsoft Money to a spreadsheet program in which the data can be put into the proper format. Some firms specialize in preparing court accountings.

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§7.55B 2. Attorney Prepares Account

If the attorney prepares the accounting, the expense is paid by the trust rather than out of the trustee's fee. See chap 9. If the attorney charges a rate normally charged for legal advice, it can be too expensive to have the accounting prepared by the attorney. Often paralegals in the attorney's office prepare the accountings for the attorney's clients, and the trustee is billed at the paralegal's hourly rate. Some attorneys charge a fixed fee for trust administration services, including preparation of an accounting. Regardless of how the services are charged, attorneys who handle a large number of estate and trust administrations should consider hiring paralegals or legal assistants with accounting and bookkeeping backgrounds to assist in the preparation of accountings.

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§7.55C 3. Accountant or Other Agent Prepares Account

If the agent is an accountant, the attorney should make certain that the agent is familiar with court accountings and the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). Most CPA firms are not familiar with the accounting format required for a court accounting and their software is not designed to produce one. Furthermore, most CPA firms are focused on preparing an accounting for income tax purposes rather than for trust accounting purposes. Particularly when there are both income and principal beneficiaries, the agent preparing the accounting should be familiar with the differences between tax accounting and the UPAIA. For example, capital gains are considered income for income tax purposes but are considered principal under the UPAIA, and are therefore not distributable to the income beneficiary. This lack of understanding may result in having to revise the accounting for an additional cost or, worse, result in inaccurate distributions to the income beneficiary. If the accounting fee is excessive, or distributions are incorrect, the trustee may be surcharged.

PRACTICE TIP 1: Some courts keep lists of individuals and firms that are able to prepare a proper court accounting. If the accounting is complex, the attorney might make a case for allowing the account preparation fee to be paid in addition to the trustee's fee.

PRACTICE TIP 2: There are many computer programs available to assist in the preparation of accountings. A simple spreadsheet system like the kind found in the disk accompanying this publication could greatly simplify the process. See §7.126 for an explanation of how to use the spreadsheet.

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§7.56 D. When to Account

The trustee is required to render accounts at least annually for trusts created by instruments, including wills, executed on or after June 30, 1987. See Prob C §16062. Trustees are also required to account when there is a change of trustee and when the trust terminates. Prob C §16062(a). The required contents of the account are specified in Prob C §16063. See §7.60.

The frequency of an individual trustee's rendering of accounts to the beneficiaries depends on many factors, including the size of the trust, types of investments, and the variety and complexity of the services the trustee is performing. For most trusts, an annual accounting is sufficient.

The trustee should consider accounting more frequently if:

- The trust is very large;
- The accounting is extensive because of assets such as a business operation;
- The trust is incurring unusual expenses;
- Unusual market events are occurring;
- Legal action is pending;
- The trustee is making large discretionary payments; or
- The trustee's attorney, or other agents or employees of the trust, are performing extra services.

Corporate trustees often send financial information to beneficiaries every month or quarter. Their statements disclose all receipts and disbursements and contain a list of assets. The frequency and style of the statement vary from corporation to corporation and according to the size or complexity of the trust and the degree of concern or interest expressed by the beneficiaries.

It is good practice to keep beneficiaries currently advised of the trust's status, thus promoting confidence that the trustee is acting in their best interests. This substantially reduces the need for them to take court action to obtain information. The trustee also must report on reasonable request of the beneficiary. Prob C §16061. See §2.6.

NOTE: The trustee of a trust created by a will executed before July 1, 1977, that has been removed from court jurisdiction under former Prob C §1120.1a must continue to account as though that provision still existed, but an account that satisfies Prob C §16063 is deemed satisfactory. Prob C §16062(d).

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§7.56A 1. Petitioning Court to Compel Report or Account

Beneficiaries of any trust may petition the court under Prob C §17200(b)(7) to compel the trustee to report or account when the trustee has not rendered a report or account within 60 days after a beneficiary's written request or in the 6 months preceding that request. The court may, in its discretion, reject the accounting request when it appears that the accounting is not "reasonably necessary for the protection of the interests of the trustee or beneficiary." Prob C §17202. See chap 15 on procedures to compel an account and for proceedings under Prob C §850(a)(3) concerning trust assets.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.56B 2. Petitioning Court to Approve Report or Account

§7.56B 2. Petitioning Court to Approve Report or Account

A trustee who renders an account to the beneficiaries may petition the court under Prob C §17200(b)(5) to have his or her account settled and approved. In such a case, the account must be submitted to the court in a specific format. See §§7.66-7.124 for the format and form of a court account. The benefit of petitioning for approval is to limit the period of time during which a beneficiary may challenge the account to the period of an appeal of the order approving the account. See §7.124. The procedure for giving notice of proposed action may not be used for the settlement of accounts. Prob C §16501(d)(3).

CAUTION: Filing the Prob C §17200(b)(5) petition gives the probate court general jurisdiction over the trust and "activates the probate court's duty and authority to scrutinize [the trustee's] account." *Schwartz v Labow* (2008) 164 CA4th 417, 427, 78 CR3d 838. In *Schwartz*, as a result of objections to the account and evidence presented, the trial court removed the trustee as part of its order on the petition. The court of appeal held that the trustee's own petition to approve the account granted the court jurisdiction and no separate petition for removal was required.

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§7.57 E. Exceptions to Accounting Requirements

Probate Code §16064 specifies exceptions to the accounting requirements. An account is not required if the trust instrument waives it. Prob C §16064(a). However, if the sole trustee is a disqualified person under Prob C §21350.5, the waiver in the trust is void as contrary to public policy. Prob C §16062(e). The Prob C §16062 duty to account does not apply to trustees of a living trust created by an instrument executed before July 1, 1987. Prob C §16062(b). The trustee of a trust created by a will executed before July 1, 1987, is likewise not subject to the §16062 duty to account annually unless the trust has been removed from continuing court jurisdiction under Prob C §§17350-17354. Prob C §16062(c).

There appears to be a gap in the coverage of the statutes. Probate Code §16062(c) does not require annual accountings of a trustee of a trust created before July 1, 1987. However, trusts subject to continuing court jurisdiction are those created by a will executed before July 1, 1977, and not incorporated by reference thereafter. A trust created by a will executed between those dates would appear to be subject neither to continuing court jurisdiction nor to the annual accounting requirement of §16062(a). Of course, the trustee still has informational obligations under Prob C §§16060-16061 and can be required to account under Prob C §17200(b)(7). See §7.56A.

NOTE: The notice of proposed action procedure does not provide an exception to the accounting requirements. Prob C §16501(d)(3).

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§7.58 1. Waiver of Account

A beneficiary may waive in writing the right to a report or account from the trustee. See Prob C §16064(c). The waiver, however, can be withdrawn in writing at any time "as to the most recent account and future accounts." Prob C §16064(c). In addition, a Prob C §16064 waiver has no effect on the beneficiary's right to petition for a report or account under Prob C §17200. Even if the trust instrument contains a waiver, a court may require an accounting if there is a showing that it is reasonably likely that a material breach of trust has occurred. Prob C §16064(a). If the sole trustee is a disqualified person under Prob C §21350.5, the waiver provision in the trust instrument is void as contrary to public policy. Prob C §16062(e).

Because there is no practical way to secure a permanent waiver, and a written waiver of accounting is of value only as long as the beneficiaries do not change their minds, a trustee should consider preparing an account even if the beneficiaries are willing to waive it. It is easier for the trustee to account and be prepared to defend the matters that the account discloses when the facts are fresh.

NOTE: The protection of Prob C §16461 for a provision in the trust instrument relieving a trustee of liability (see §§7.53, 7.65) is unavailable on waiver of account.

For a form of waiver, see §7.59.

NOTE: Under Prob C §16062(e), a waiver in a trust instrument of the obligation to account is against public policy and is void for any sole trustee who is a disqualified person under Prob C §21350.5.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.59 2. Form: Waiver of Account

§7.59 2. Form: Waiver of Account

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I, _ _[*name of beneficiary*]_ _, being a beneficiary of the _ _[*name*]_ _ Trust, and being competent and over the age of majority, hereby waive my right to an account by _ _[*name of trustee*]_ _

[*If appropriate, add*]

for the period of _ _[*date*]_ _ to _ _[*date*]_ _.

[*Continue*]

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: The waiver may have limited utility. See discussion in §7.58.

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§7.60 F. Contents of Account

Probate Code §16063(a) specifies that an account to trust beneficiaries must contain the following:

- A statement of the receipts and disbursements of principal and income that have occurred during the last complete fiscal year of the trust or since the last account;
- A statement of the trust's assets and liabilities as of the end of the last complete fiscal year of the trust or as of the end of the period covered by the account;
- The trustee's compensation for the last complete fiscal year of the trust or since the last account;
- The agents hired by the trustee, their relationship to the trustee, if any, and their compensation for the last complete fiscal year of the trust or since the last account;
- A statement that the recipient of the account may petition the court under Prob C §17200 to obtain court review of the account and the trustee's acts; and
- A statement that claims against the trustee for breach of trust may not be made after the expiration of 3 years from the date the beneficiary receives an account or report disclosing facts giving rise to the claim. See §7.64A.

In addition, Cal Rules of Ct 7.902 requires the account to state the names and last-known addresses of all vested or contingent beneficiaries (except for those who need not be given notice under Prob C §15804). For a revocable trust, only persons holding power to revoke need to be listed.

As long as the items stated in Prob C §16063(a) are present, the account do not have to be in the form specified for court accounts. This makes it easier to attach receipts and disbursements schedules produced by financial management programs such as Microsoft Money, Quickbooks, or Quicken, which cannot be customized.

A trust provision that releases the trustee from liability if a beneficiary fails to object to an item in an account or report within a specified time period is effective if the requirements of Prob C §16461(c) (see §7.65) are met. Among other requirements, the report or account must include a notice to beneficiaries in 12-point boldface type with the language set out in §16461(c).

When a trust contains both community property and separate property, the account should make clear which assets and transactions pertain to separate property so that the property is not commingled at the risk of losing its separate character.

For a form of letter to accompany the account, see §7.61.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.61 1. Form: Letter to Beneficiary About Account

§7.61 1. Form: Letter to Beneficiary About Account

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

_ _[*Date*]_ _

To: _ _[*name of beneficiary*]_ _

_ _[*Address*]_ _

Re: _ _ _ _ _ _ **Trust**

Accounting for period beginning _ _[*date*]_ _ **and ending** _ _[*date*]_ _

Dear _ _ _ _ _ _:

Beneficiaries are entitled to receive an accounting containing the following information:

1. Receipts and disbursements of principal and income that have occurred during the last complete fiscal year of the trust or since the last account.

2. Assets and liabilities of the trust as of the beginning of the period and as of the end of the period covered by the accounting.

Enclosed with this letter are schedules showing this information.

Information concerning fees paid to _ _[*name of trustee*]_ _ **as trustee or to** _ _[*its/his/her*]_ _ **agents appears in the disbursement schedule. Unless otherwise indicated, agents of the trustee are neither related to nor affiliated with the trustee.**

_ _[*We/I*]_ _ _ _[*are/am*]_ _ **also required to notify you that you are entitled under Probate Code §17200 to petition the court to obtain a court review of the account and of the acts of the trustee. Claims against the trustee for breach of trust may not be made after the expiration of 3 years from the date you receive an account or report disclosing facts giving rise to the claim. See Probate Code §16063.**

[*If Prob C §16461 applies and the trustee elects to give the required notice, add*]

However, this 3-year period is shortened to _ _[*180 days/*_ _[*period shorter than 180 days specified in trust instrument*]_ _ *but this period is lengthened 180 days by Probate Code §16461(d)/*_ _[*period longer than 180 days specified in trust instrument*]_ _]_ _**. Probate Code §16461(c) requires the trustee to give you the following notice:**

[*In boldface 12-point type*]

YOU HAVE _ _[*180 DAYS/*_ _[*period longer than 180 days specified in trust instrument*]_ _]_ _ **FROM YOUR RECEIPT OF THIS ACCOUNT OR REPORT TO MAKE AN OBJECTION TO ANY ITEM SET FORTH IN THIS ACCOUNT OR REPORT. ANY OBJECTION YOU MAKE MUST BE IN WRITING; IT MUST BE DELIVERED TO THE TRUSTEE WITHIN THE PERIOD STATED ABOVE; AND IT MUST STATE YOUR OBJECTION. YOUR FAILURE TO DELIVER A WRITTEN OBJECTION TO THE TRUSTEE WITHIN THE PERIOD STATED ABOVE WILL PERMANENTLY PREVENT YOU FROM LATER ASSERTING THIS OBJECTION AGAINST THE TRUSTEE. IF YOU DO MAKE AN OBJECTION, THE 3-YEAR PERIOD PROVIDED IN SECTION 16460 OF THE PROBATE CODE FOR COMMENCEMENT OF LITIGATION WILL APPLY TO CLAIMS BASED ON YOUR OBJECTION AND WILL BEGIN TO RUN ON THE DATE THAT YOU RECEIVE THIS ACCOUNT OR REPORT.**

[*Continue*]

[*Add if trust instrument provides for alternative dispute resolution*]

Please also take notice of Article _ _[*number or letter of relevant section of trust instrument*]**_ _ of the _ _**[*Declaration of Trust/Trust Agreement*]**_ _, which requires that you take the following steps before the filing of any claim or petition with the Superior Court: _ _**[*list provisions of trust instrument*]**_ _**

[*Continue*]

If you have any questions concerning the trust or the accounting, please call me at _ _[*telephone number*]**_ _.**

Very truly yours,

__[*Signature of trustee*]__
_ _[*Typed name*]_ _

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§7.62 2. Format of Account

Whether the trust is a simple or a complex trust, the nature of the assets determines what types of schedules are needed. Even though the Probate Code identifies certain schedules, not all are needed in every account. In other instances, additional schedules are needed to convey information in a logical and easily understandable way (*e.g.,* an Addition to Assets schedule and a Principal Receipts schedule are used to distinguish receipts of assets from receipts of cash in a net income trust when a cash summary is needed).

The authors have found that most courts allow entries in an accounting to be either by date or by category. Probate Code §16063, which details the contents of the account, does not specify the format of the account. Consult local rules before making a decision. Some courts require that additional information, *e.g.,* the original bank or brokerage statements, which include balances, be provided at the end of the account, along with a reconciliation.

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§7.63 3. Use of Categories in Account

If at all possible, categorize receipts and disbursements. Doing so makes it easier to prepare a tax return and to determine that a receipt is missing, *e.g.,* a third-quarter dividend payment or a social security check. Categorization also makes it easier to discover missing information in the event the account does not balance, and can aid in keeping separate property items separate from community property items. Finally, when reviewing a particular investment, it is helpful to see whether dividends are increasing or decreasing.

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§7.64 4. Incorporating Reports by Agents in Account

If the trustee uses agents for the custody of securities or for property management, reports provided by those agents may be incorporated into an account and sent directly to the trust beneficiary. Information contained in these reports should be summarized by explanations in the receipts schedule, *e.g.,* "net income for the month of _____, from _____." However, while this is common practice and may be acceptable to most beneficiaries, some courts will require a complete itemization of the information.

PRACTICE TIP: Accounting for reports of certain agents of the trustee, such as a professional investment advisor, arguably could have the effect of limiting the period during which an action may be brought against the agent (see §§7.64A-7.65, 7.67), whether by the trustee or a successor trustee or by a beneficiary. If any claim against such an agent exists, the trustee may wish to include information with respect to the potential claim in the account and list the potential claim in the schedule of trust property on hand at the end of the account (see §7.98). The trustee also may wish to include allegations of the trustee's reasonableness or prudence in selecting the agent and a statement that the accounting and report is with respect to the acts of the trustee, including transactions by the agent on behalf of the trustee, and not with respect to the agent's professional services or other matter of the potential claim.

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G. Liability Protection Afforded by Account

§7.64A 1. Shortened 3-Year Statute of Limitations

Ordinarily, an action for breach of trust has a 4-year statute of limitations from the date the "cause of action shall have accrued." CCP §343. The time during which a person is under the age of majority or insane is not part of the accrual period (CCP §352(a)), and imprisonment can postpone the accrual period for up to 2 years (CCP §352.1(a)). If a competent adult beneficiary who receives an account under Prob C §16063 wishes to pursue a claim against the trustee for breach of trust, the claim must be filed within 3 years after receipt of the account or report. Prob C §16460(a)(1).

PRACTICE TIP: This shortened 3-year statute of limitations may also apply to incapacitated adult and minor beneficiaries if the account is served on the legal representative, guardian, or parents under Prob C §16460(b). However, under CCP §352.1(a) the statute of limitations may still be extended up to 2 years for beneficiaries in prison. See discussion in §§7.65B-7.65G.

In *Noggle v Bank of America* (1999) 70 CA4th 853, 82 CR2d 829, the court held that the 3-year statute of limitations on a proceeding against a trustee for breach of fiduciary duty begins to run from the date the beneficiary receives an account or report that contains sufficient information so that the beneficiary knows of the claim or reasonably should have inquired into the existence of the claim, regardless of whether the written account or report satisfies the requirements of Prob C §16061 or §16063. If the accounting does not disclose adequately the grounds of the claim, or if a beneficiary does not receive any written account or report, the statute of limitations on actions against the trustee begins to run when the breach is discovered or reasonably should have been discovered. Prob C §16460(a)(2).

NOTE: To start the 3-year period running, the account must contain language substantially the same as the following: "You are entitled, under Probate Code §17200, to petition the court to obtain a court review of the account and of the acts of the trustee. Claims against the trustee for breach of trust may not be made after the expiration of 3 years from the date you received an account or report disclosing facts giving rise to the claim." See Prob C §16063(a)(5)-(6). But see *Noggle v Bank of America* (1999) 70 CA4th 853, 82 CR2d 829, concerning substantial compliance even in the absence of such notice. Unlike the liability limitation notice language of Prob C §16461(c)(3), which must be in boldface 12-point type (see §7.65), there are no type specifications for statements under Prob C §16063(a)(5)-(6). Many corporate fiduciaries are including these statements on their computer-generated monthly account statements (which beneficiaries often overlook).

PRACTICE TIP: To further limit the time within which a beneficiary may contest the account, submit the account to the court for approval. See §7.66. Once an order approving the account is obtained, and the time for filing an appeal has expired (see §7.124), a beneficiary's ability to challenge will cease if proper notice of the petition and adequate disclosure in the account are made.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.65 2. Limitation of Liability in Trust Instrument

§7.65 2. Limitation of Liability in Trust Instrument

A trust instrument may contain language relieving the trustee of liability for a breach of trust if the beneficiary fails to object to a trustee's account or report within a specified period of time, which cannot be less than 180 days. Prob C §16461. The provision does not shorten the 3-year statute of limitations for commencement of a proceeding to assert a claim against the trustee for breach of trust under Prob C §16460, but it may relieve a trustee from personal liability for such claim. Prob C §16461(i). However, Prob C §16461 will not relieve the trustee of liability for a breach of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the beneficiary's interest, nor for any profit the trustee derived from a breach of trust. Prob C §16461(b).

NOTE: The trustee's liability to incapacitated adult and minor beneficiaries does not appear to be addressed in Prob C §16461. However, it appears that service of the notice under Prob C §16460(b) will be effective. See discussion in §7.65D.

For the trust provision to be effective, the account or report must include a prescribed form of notice in 12-point boldface type, informing the beneficiaries of their right to object within the specified time, the manner in which to object, and the commencement of the 3-year period in Prob C §16460. Prob C §16461(c)(3). A trust provision that specifies an objection period of less than 180 days will be deemed ineffective unless the trustee elects to comply with the 180-day statutory requirement and specific notice requirements set forth in §16461. Prob C §16461(d). A beneficiary who fails to object in writing within the specified time period (not less than 180 days) is barred from asserting any claim against the trustee regarding an item that is adequately disclosed in the account or report. Prob C §16461(e). Notice given in the form prescribed by Prob C §16461(b) excuses compliance with Prob C §16063(c)(6). Prob C §16461(h). For a form of notice, see the form letter to beneficiary in §7.61.

PRACTICE TIP: If the trust instrument does not contain a provision relieving the trustee of liability for items in the account or report, when there is good cause, the trustee might consider seeking a modification of the trust instrument to so provide.

The following table illustrates the differences between Prob C §16063 notice and Prob C §16461 notice:

Probate Code §16063 Notice	Probate Code §16461 Notice
Shortens CCP §343 4-year statute of limitations for breach of trust to 3 years under Prob C §16460.	A claim for breach of trust may not be filed unless written objections are first delivered to the trustee within the notice period (no less than 180 days).
Shortens statute of limitations only as to beneficiaries actually served. Service on incapacitated persons or minors may be made through legal representative, guardian, or parent. Prob C §16460(b).	Applies only to beneficiaries actually served. Statute is silent as to service on incapacitated persons or minors. However, it is likely that Prob C §16460(b) applies. See §7.65E.
The time limitation is met by filing a court proceeding (a "claim") for breach of trust.	The time limitation is met by: (1) delivering to the trustee written objections (Prob C §16461(c)(3)); (2) filing objection to an account or report and delivering them to the trustee (Prob C §16461(e)); or (3) an affected beneficiary joining another's timely filed (with the court)

	and delivered (to the trustee) objection to account or report prior to their resolution or expiration of the time period, whichever is later (Prob C §16461(f)).
Available for use by all trusts.	Available for use only if the trust instrument so specifies.

The notice periods under Prob C §16063 and Prob C §16461 both commence on the beneficiary's *receipt* of the notice. Confirmation of receipt by an individual addressee may be obtained by use of United States Postal Service (USPS) Restricted Delivery combined with Delivery Confirmation, Signature Confirmation, or Return Receipt. Other delivery options from overnight carriers and the USPS may give proof of delivery, but if the individual beneficiary does not sign for receipt of the package, they will give proof only of delivery to the address, not receipt by the beneficiary.

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H. Court Account Versus Account to Beneficiaries

§7.65A 1. Balancing of Interests

The decision whether to present a Prob C §16063 information report or account (with the Prob C §16461 notice, if applicable) to the beneficiaries or, alternatively, to file a court account, requires a balancing of interests. The trustee and the beneficiaries presumably share a desire to minimize costs and protect the privacy of trust records, assets, and beneficiary information, but beyond that their interests may diverge.

The trustee will want potential liability exposure to be reasonably minimized (see §7.65B), and will want to keep sufficient assets in the trust to cover any future claims by a beneficiary.

Beneficiaries may wish to avoid the trustee or attorney fees incurred if the trustee files a court account, or may wish to avoid the extent of accounting costs required in preparation of an account in the full format required for the court. Typically, beneficiaries will also want distributions as soon as possible, without the trustee's retention of funds to cover possible future claims.

Probate Code §16461 was created to provide an effective means to relieve trustees of liability in using the Prob C §16063 information report or account without court supervision. See §§7.53, 7.65. If the requirements of Prob C §16461(c) are met, the interests both of the trustee and the beneficiaries are met.

If Prob C §16461(c) is not available, there seems to be no Probate Code authority making approval of an account or indemnity of the trustee a prerequisite to a distribution. However, the trustee does have a right to file an account with the court under Prob C §17200(a) and (b)(5), and it seems unlikely that any court would refuse reasonable accounting fees to a trustee. In *Kasperbauer v Fairfield* (2009) 171 CA4th 229, 88 CR3d 494, the court implemented the common law right of the trustee to indemnification from the beneficiaries by ordering reimbursement of $250,000 from a beneficiary personally for legal expenses incurred by the trustee in preparing an account and defending it against the beneficiary's objections. Beneficiaries who desire quicker distributions, reduced accounting and legal fees, and greater privacy may find it in their interests to sign waivers of court account and approval of Prob C §16063 accounts.

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§7.65B 2. Minimizing Trustee's Liability Exposure in Noncourt Accounts

It may be possible to have a degree of certainty regarding the termination of a trustee's liability exposure similar to that afforded by a court account, provided the account is made not only to persons entitled to an account under Prob C §§16062 and 16064, but to all persons who would otherwise be entitled to notice were the account to be filed with the court. See §§7.118-7.119.

PRACTICE TIP: Be cautious about creative trust provisions. In *Vena v Vena* (Ill App 2008) 899 NE2d 522, for example, the trust instrument provided that a "majority in interest of the [income beneficiaries] may at any time approve the trustee's accounts… with the same effect as if a court having jurisdiction over the trust approved the accounts." One of 19 beneficiaries objected to the trustee's account. The court held that the majority-approval provision was void because it did not provide effective trustee oversight, could be manipulated by the trustee with respect to which beneficiaries were sent the accounting, and raised public policy concerns as an exculpatory clause.

The trustee has maximum protection from further liability exposure when all beneficiaries (present and remainder or contingent) in being are noticed as described in §§7.65C-7.65E. Other avenues to limiting a trustee's liability are explored in §§7.65F-7.65G.

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§7.65C a. Protecting Against Claims of Remainder and Contingent Beneficiaries

The trustee may be concerned about future claims by remainder beneficiaries, even with an account satisfying the notice requirements of Prob C §16063. See, *e.g.*, *Dennis v Rhode Island Hosp. Trust Co.* (1st Cir 1984) 744 F2d 893 (upholding claims of remainder beneficiaries based on failure to sell property that later depreciated). The 3-year statute of limitations under Prob C §16460 and the 180-day period under Prob C §16461 (see §7.65) are effective only as to beneficiaries who actually receive the account.

A further source of concern is that the lead California case interpreting Prob C §16063 (*Noggle v Bank of America* (1999) 70 CA4th 853, 82 CR2d 829) applied only to competent adult beneficiaries who had received account information or notice of hearing of the court proceeding (when the trust was under court jurisdiction). It did not address minors, incapacitated persons, remainder beneficiaries not noticed, or unborn or unascertained persons. See §7.64A.

It seems that service of an account on all persons who must receive notice under Prob C §15804 (future interests of beneficiaries) should be sufficient to terminate a trustee's liability exposure as to remainder beneficiaries, including unborn and unascertained persons. This result is implied by Prob C §15804(d) ("[a]s used in this section, 'notice' includes other papers") and Cal Rules of Ct 7.902 (the list of all beneficiaries in the petition or account need not include "any beneficiary who under Probate Code section 15804 need not be given notice"). See also Comment to Prob C §15804 ("Subdivision (d) has been added to make clear that other papers, such as accounts to beneficiaries under Section 16062, are covered by the rules governing notice in this section"). These rules generally provide that notice must be given to persons in being who would be entitled to an interest if a certain future event happened immediately before the commencement of the proceeding, without regard to whether the interest is further limited by additional future events. Prob C §15804(a)(1), (3).

The common law doctrine of virtual representation also may enhance the application of Prob C §15804 as to service of an account. See Restatement (Third) of Trusts §82(1)(c), Comment a(1) (2007) (fairly representative beneficiaries). See also Restatement (Second) of Trusts §216, Comment h (1959) (consent by person holding general power of appointment precludes claim by appointees of property). Under the common law doctrine of virtual representation, current beneficiaries may represent unavailable beneficiaries, especially the unborn, provided there is no conflict between the representative and the represented. *Estate of Sankey* (1926) 199 C 391, 249 P 517; *County of Los Angeles v Winans* (1910) 13 CA 234, 109 P 640; *Estate of Lacy* (1975) 54 CA3d 172, 126 CR 432; *Estate of Benziger* (1943) 61 CA2d 628, 143 P2d 717. Common law governs trusts except as modified by statute. Prob C §15002. Thus, it appears that a trustee's account served on persons required to be noticed as beneficiaries under Prob C §15804 will satisfy claims of all future interests, including unborn and unascertained beneficiaries.

PRACTICE TIP: Practitioners may wish to include in the account or report specific allegations as to satisfaction of Prob C §15804 and why the persons being served as representative persons have no conflicts of interest with the persons they are representing (or recital as to compliance with Prob C §15804(b)).

If all persons required to be noticed under Prob C §15804 are in being, and there is little or no possibility that later-born or later-adopted persons will need to be included, there should be no need for a guardian ad litem (Prob C §1003; CCP §373.5) for unborn or unascertained persons. If all such possible persons are not yet in being, the trustee may want to have a guardian ad litem appointed. See Prob C §15804(c)(2).

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§7.65D b. Protecting Against Claims of Minors and Incapacitated or Incarcerated Persons

The time during which a person is under the age of majority or insane is not part of the accrual period for running a statute of limitations (CCP §352(a)), and imprisonment can postpone the accrual period for up to 2 years (CCP §352.1(a)). This applies to the default 4-year statute of CCP §343 as well as to the shortened 3-year limitations period under Prob C §16460(a)(1). However, the 3-year statute can be commenced as to incapacitated adult and minor beneficiaries by service of the account on the legal representative, guardian, or parents under Prob C §16460(b).

NOTE: Some accounting or sufficient disclosure to a minor's parents (complying with Prob C §16460(b)) serves to commence the 3-year statute of limitations, whereas disclosure only to adult beneficiaries when no disclosure is attempted on minors (*e.g.,* service solely on parents as beneficiaries, but not minors as contingent beneficiaries) would not commence either the 3-year or 4-year statute.

In light of the apparent equivalency of "notice" with an account and "other papers" under Prob C §15804(d) and Cal Rules of Ct 7.902 (see §7.65C), the trustee should make sure that each minor or incapacitated beneficiary entitled to notice (see §§15.21A-15.21B) is served with the account. The notice and account to these beneficiaries should meet the following conditions:

- Each person receives a completely separate account (even if it is being sent to the same person in different capacities, or to several persons having the same address);
- Any minor or conservatee, as well as the legal guardian or conservator, is sent a copy of the account (Cal Rules of Ct 7.51(c));
- Both minors and the persons who have legal custody are given separate notice in addition to their guardian (Cal Rules of Ct 7.51(d)); and
- Any potential conflict of interest by virtual representation under Prob C §15804(a) (relating to future interests) is satisfied by additional notice under Prob C §15804(b).

In addition, counsel should consider whether it might still be necessary to appoint a guardian ad litem (Prob C §1003) if the interests of minor, unborn, or unascertained persons are not otherwise adequately represented. See §§15.16-15.19A. Counsel should also consider making disclosures in the account as to a person's representative capacity under Prob C §15804 and showing that there are no conflicts of interest (in particular, that persons virtually represented have the same income or principal interests as the persons actually represented).

There appears to be no way to eliminate the extra period (up to 2 years) for incarcerated persons under CCP §352.1(a) other than by the beneficiary's release. See form in §7.65G.

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§7.65E c. Availability of Prob C §16461 180-Day Notice Period on Noncourt Account to Minors and Incapacitated Persons

Probate Code §16461 is silent as to minors and incapacitated persons. The legislative history of AB 1990 (Stats 2004, ch 538) is similarly silent. Therefore, in the absence of specific terms in the trust instrument relieving the trustee of liability pertaining to minors or incapacitated beneficiaries, the term "beneficiary" as defined in Prob C §24 (which makes no distinction for minors or incapacitated persons) will apply. The provisions of Prob C §16461 similarly apply to all beneficiaries, as long as notice and account requirements to minors and incapacitated persons are met. See §7.65D.

As to whether a Prob C §16461 notice on a minor or incapacitated person may be satisfied by complying with Prob C §16460(b), Prob C §16461(c)(3) anticipates the notice to be included with the account or report, which reflects Prob C §16460(a)(1). Similarly, the unspecified use of the term "beneficiary" implies the inclusiveness of Prob C §24. Therefore, it appears that compliance with Prob C §16461(b) for service on minors and incapacitated persons would satisfy service requirements of the Prob C §16461(c)(3) notice.

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§7.65F d. Other Liability Limitations and Exculpation of Trustee

Several other avenues are available to limit a trustee's liability or to exculpate him or her, depending on the circumstances. For example, a trustee is not liable to a beneficiary for action or inaction pursuant to the written direction of the person holding the power to revoke a trust. Prob C §16462. Further, a beneficiary who has consented to an act may not hold the trustee liable unless a statutory exception, such as the beneficiary's incapacity, applies. Prob C §16463.

In addition, a beneficiary's release or contract (*i.e.,* a waiver) will preclude the beneficiary from holding the trustee liable. Prob C §16464. Counsel must review Prob C §16464(b) concerning each release to make sure there are no factors that would make the release ineffective to discharge the trustee's liability. For a form of release, see §7.65G.

PRACTICE TIP: Obtaining a beneficiary's release would permit distribution of trust funds that might otherwise need to be held for a potential claim.

Note, however, that a release by a guardian ad litem or by a person in a representative capacity under Prob C §15804 must include impartiality, lack of conflict of interest, no hostility, and meaningful representation. See *Wogman v Wells Fargo Bank* (1954) 123 CA2d 657, 267 P2d 423 (CCP §373.5, which codifies doctrine of virtual representation, implicitly applies limitations on doctrine to guardian ad litem appointed for unborn or unascertained person). See §7.65C.

Another option is affirmance: If a beneficiary has affirmed the trustee's action, the beneficiary cannot later hold the trustee liable unless the beneficiary was under an incapacity or another statutory exception applies. Prob C §16465.

Finally, although a notice of proposed action by trustee cannot be used to settle an account and several other transactions (Prob C §16501(d)), the procedure may be used to reduce a trustee's liability exposure as to particular actions or transactions that will later also be shown in an account. By this means the trustee's liability exposure can be terminated before any accounting.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.65G e. Form: Beneficiary Release of Trustee

§7.65G e. Form: Beneficiary Release of Trustee

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RELEASE

_ _[*Name*]_ _ **TRUST**

I am a beneficiary under the _ _[*name*]_ _ **Trust under** _ _[*trust agreement/declaration of trust*]_ _ **dated** _ _[*date*]_ _**, and have been provided with an accounting for the Trust for the period from** _ _[*date*]_ _ **to** _ _[*date*]_ _**.**

_ _[*In order that I might receive my distribution under such Trust without further delay,*]_ _ **I hereby release** _ _[*name of trustee*]_ _**, Trustee, for any and all claims pertaining any of the acts of the Trustee reflected in such account.**

I have been advised to have this Release reviewed and explained to me by counsel of my own choosing prior to my signing, and I have had sufficient time to do so.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: Counsel should review Prob C §16464(b) to make sure there are no factors that would make the release ineffective to discharge the trustee's liability.

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§7.66 IV. COURT ACCOUNTS

A court account is a document presented by the trustee to the superior court providing detailed information about the financial status of the trust during the specified period. All accounts filed with the court under the Probate Code, including interim and final accounts, must include a financial statement and a report of administration as provided in Prob C §§1060-1064, and the names and addresses of beneficiaries as required by Cal Rules of Ct 7.902.

PRACTICE TIP: Normally, for a court account, there should be no need to distinguish in the records between the decedent's separate property and community property as to property received from a decedent into the trust, unless there is a special need to do so according to the terms of the trust instrument.

The account is presented to the court under Prob C §17200(b)(5), which authorizes a trustee to bring a petition "[s]ettling the accounts and passing upon the acts of the trustee, including the exercise of fiduciary powers."

CAUTION: Filing the petition gives the probate court general jurisdiction over the trust. See §7.56B.

Unless specifically provided elsewhere in the Probate Code, or unless good cause is shown, no information in addition to that required in Prob C §§1060-1064 and Cal Rules of Ct 7.901-7.902 need be included in an account. Prob C §1060; Cal Rules of Ct 7.901-7.902. The contents of a court account (including those required under Cal Rules of Ct 7.903(c)(6); see §7.1 (trusts funded by court order)) are governed by Prob C §§1060-1064. See §7.71.

When a trustee files a proper verified account (see §7.115), the trustee establishes a prima facie case of the "verity of its entries." *Estate of Miller* (1968) 259 CA2d 536, 549, 66 CR 756. If the entries are contested, the burden shifts to the trustee to submit evidence supporting the accounts filed. *Estate of Miller, supra*. If the beneficiary alleges breach of trust and violation of the trustee's investment duties, the beneficiary has the burden of proving the trustee's failure to meet its duties. If the beneficiary meets that burden of proof, then the burden shifts to the trustee to justify its actions. *Van de Kamp v Bank of America* (1988) 204 CA3d 819, 853, 251 CR 530. See also Prob C §16004(c) regarding the presumption that transactions between trustee and beneficiary for which the trustee obtains an advance violate the trustee's fiduciary duties.

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§7.67 A. When Court Account Required

There is no statutory period for accounts of trusts under continuing court supervision. Certain local court rules suggest the frequency of accounting. Factors to consider in deciding whether the timing suggested in local rules should be followed include (1) the cost of account preparation, (2) the need for court approval of trustee actions, and (3) the trustee's or the trustee's attorney's desire to be paid. In any case, a beneficiary of either a court-supervised trust or a nonsupervised trust may petition the court to order the trustee to account after giving a 60-day written request for an accounting to the trustee when the trustee has not provided an accounting within 6 months. Prob C §17200(b)(7). The court must then balance the beneficiaries' interests against those of the trustee and the trust in deciding whether to order the account. Prob C §17202.

For trusts not under continuing court supervision, the trustee is not required to seek court approval of accounts to beneficiaries that are mandated under Prob C §16062. The trustee may nevertheless seek court approval to limit the period of trustee liability for actions taken during the accounting period or, *e.g.,* if there have been disputes with beneficiaries regarding the administration of the trust. See Prob C §17200(b)(5). When the trust is not under continuing court supervision, a showing must be made that the petition and account is reasonably necessary to protect the interests of the trustee or the beneficiary. See Prob C §17202. The statute of limitations will be reduced from 3 years to 180 days from the date of the court order if no appeal is filed. The appeal period can be further reduced by the mailing of a notice of entry of the order. See §7.124.

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§7.68 1. Waiver of Court Account

Unless Prob C §16064 is construed as applying to supervised trusts, there is no statutory or case law supporting a waiver of account for a supervised trust. When waiver of the account for a supervised trust appears logical, the attorney for the trustee may follow Prob C §10954 by analogy. If the sole trustee is a disqualified person under Prob C §21350.5, a waiver provision in the trust instrument is void as contrary to public policy. Prob C §16062(e).

NOTE: If a court account is waived under Prob C §10954, the report need not list the details of receipts and disbursements but must still include information about creditors' claims; sales, purchases, or exchanges of assets; assets on hand; administration costs; and certain other required information. It must also include detailed schedules of receipts and gains or losses on sales unless the inventory and appraisal is used as the basis for calculating fees. Cal Rules of Ct 7.550. Presumably, this would also be true of a waiver of an account for a supervised trust.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.69 2. Form: Waiver of Court Account

§7.69 2. Form: Waiver of Court Account

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In re Trust created under the Will of _ _[*name of decedent*]**_ _, Deceased**	**No. _ _ _ _ _ _** **WAIVER OF ACCOUNT** **Hearing: _ _**[*date*]**_ _** **Time: _ _**[*time*]**_ _** **Dep't: _ _**[*number*]**_ _**
[*Or*]	
In re _ _[*name*]**_ _ Trust, Established _ _**[*date*]**_ _**	

I, _ _[*name*]**_ _, being a beneficiary of the Trust created under the Will of the above-named decedent, and being competent and over the age of majority, hereby waive the filing and settlement of an account by _ _**[*name of trustee*]**_ _ _ _**[*if acting also in a representative capacity (see §7.65C) add capacity; e.g., on behalf of myself and all of my issue*]**_ _.**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

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§7.70 B. Venue for Court Account

An account of a supervised testamentary trust is filed in the court in which the will was probated unless jurisdiction has been transferred. Prob C §17301. See Prob C §§17304, 17200(b)(17) (transfer of jurisdiction over trust to another county). Petitions to settle accounts of living trusts are filed in the county where "the principal place of administration of the trust" is located. Prob C §17005(a)(1). This is defined in Prob C §17002(a) as "the usual place where the day-to-day activity of the trust is carried on by the trustee or its representative who is primarily responsible for the administration of the trust." If there are cotrustees, the principal place of administration is the residence or usual place of business of any cotrustee as agreed; or, if none, the county where any cotrustee resides or maintains a place of business. Prob C §17002(b)(2).

For nonsupervised testamentary trusts, or testamentary trusts that have been removed from continuing court supervision under Prob C §§17350-17354, proper venue is either the county of the principal place of administration of the trust or the county that had jurisdiction over the administration of the estate. Prob C §17005(a)(2).

The rules applicable to civil actions generally govern venue of an account filed by a trustee of a nonsupervised nontestamentary trust. Prob C §17005(c).

See also §§15.2-15.12.

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C. Contents and Form of Court Account

§7.71 1. Summary of Account

The account must state the period covered (Cal Rules of Ct 7.901(a)) and contain a summary showing all of the following, to the extent applicable (Prob C §1061(a)):

- Property on hand at the beginning of the period covered by the account (all inventories);
- Assets received during the accounting period, excluding property listed in an inventory;
- Receipts, excluding items listed under items (1) and (2) or receipts from a trade or business;
- Net income from a trade or business;
- Gains on sales;
- Disbursements, excluding disbursements for a trade or business or distributions;
- Loss on sales;
- Net loss from a trade or business;
- Distributions to beneficiaries, the ward, or conservatee; and
- Property on hand at the end of the accounting period, stated at its carry value (fiduciary acquisition value).

The Summary of Account, showing charges and credits, must be in a format substantially similar to that set out in Prob C §1061(b), except that inapplicable categories need not be shown. Total charges must equal total credits. Prob C §1061(c).

The terms "net income" and "net loss" are to be used according to general accounting principles, and there is no requirement that the terms be used as reflected in the tax returns governing the period of the account. Prob C §1061(d).

The Summary of Account is incorporated in the petition for settlement of account filed with the court. For an example of a Summary of Account for three common types of trusts, see §7.72.

In the example represented by the Summary of Account and other schedules in §§7.72-7.111, the surviving spouse uses an administrative trust for 1 year after the death of the first spouse. See §§14.2-14.6. At the end of 1 year, the trust assets are allocated between a credit shelter trust and a marital deduction trust, which are then administered separately for a second year.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.72 a. Form: Summary of Account

§7.72 a. Form: Summary of Account

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Doe Administrative Trust
Summary of Account
January 1, 2009-December 31, 2009

CHARGES	
Beginning Assets (Schedule _ _[*letter*]_ _):	2,646,693.00
Additions to Assets (Schedule _ _[*letter*]_ _):	2,125.00
Receipts (Schedule _ _[*letter*]_ _):	13,104.91
Gains on Sales (Schedule _ _[*letter*]_ _):	2,218.16
	2,664,141.07
CREDITS	
Disbursements (Schedule _ _[*letter*]_ _):	16,039.00
Specific Devises (Schedule _ _[*letter*]_ _):	32,170.00
Ending Assets (Schedule _ _[*letter*]_ _):	2,615,932.07
	2,664,141.07

Doe Marital Trust
Summary of Account
January 1, 2010-December 31, 2010

CHARGES	
Beginning Assets (Schedule _ _[*letter*]_ _):	681,595.67
Receipts (Schedule _ _[*letter*]_ _):	5,463.31
	687,058.98
CREDITS	
Disbursements (Schedule _ _[*letter*]_ _):	7,911.00
Losses on Sales (Schedule _ _[*letter*]_ _):	50.00
Ending Assets (Schedule _ _[*letter*]_ _):	679,097.98
	687,058.98

Doe Credit Shelter Trust
Summary of Account
January 1, 2010-December 31, 2010

CHARGES	
Beginning Assets (Schedule _ _[*letter*]_ _):	2,000,000.00
Receipts (Schedule _ _[*letter*]_ _):	3,513.61
Net Income From Trade or Business (Schedule _ _[*letter*]_ _):	4,055.00

Gains on Sales (Schedule _ _[*letter*]_ _):	1,025.00
	2,008,593.61

CREDITS

Disbursements (Schedule _ _[*letter*]_ _):	1,922.00
Cash Distributions (Schedule _ _[*letter*]_ _):	3,000.00
Asset Distributions (Schedule _ _[*letter*]_ _):	700.00
Ending Assets (Schedule _ _[*letter*]_ _):	2,002,971.61
	2,008,593.61

Comment: The summary lists only those categories applicable for each trust.

Charges are those items the trustee is "charged with," *i.e.,* those items the trustee received or should have received. Credits are those items for which the trustee "receives credit," *i.e.,* disbursements made and remaining assets. Charges must equal credits or the account is out of balance.

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§7.73 b. Problems With Balancing

The total charges as shown in the Summary of Account must equal total credits. Prob C §1061(c). The most common reasons for not balancing are:

- Receipts include items listed in original inventory.
- Receipts were deposited or disbursements made during the period between distribution and receipt by the trustee.
- Reinvested dividends or interest are not included in receipts.
- Ending assets are valued at market value instead of acquisition value.
- Bank and brokerage account were not balanced, so items are wrong or missing.
- Sales, purchases, or exchanges of assets have been omitted.
- If a computer is used, certain categories of receipts or disbursements were not selected to be included in the schedule.

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§7.74 2. Required Schedules

The Summary of Account must be supported by detailed schedules under Prob C §1062. Schedules are required showing details of the first two items (*i.e.,* property on hand at the beginning of the period covered by the account and additional assets received during the account period, excluding property listed in an inventory) listed under charges in the Summary of Account. Prob C §1061(b). See §§7.71-7.72.

The following schedules are required by Prob C §1062 (see §§7.75-7.99):

- Receipts, showing the nature and purpose of each item, source of receipt, and date;
- Disbursements, including the nature or purpose of each item, name of payee, and date;
- Net income or loss from a trade or business, which will be sufficient if it provides the information disclosed on Schedule C or F of the federal income tax return;
- Calculation of gains or losses on sale or other disposition;
- Distributions of cash or property to beneficiaries, ward, or conservatee, showing date and amount of each, with the distribution of property shown at its carry value; and
- Itemized list of property on hand, describing each item at its carry value.

Additional schedules are required by Prob C §1063 and are described in §§7.100-7.111. These schedules are not referred to in the sample format of the Summary of Account set out in Prob C §1061(b), but could be added as applicable.

PRACTICE TIP: Some corporate fiduciaries have their own format for accounts, which may not comply with the Probate Code requirements in all respects. When a corporate fiduciary is not equipped to change its format for the court, the practitioner must determine whether the local superior court will accept the trustee's schedules, accompanied by a proper Summary of Account (see §7.71), and additional schedules or disclosures in the petition to satisfy the Probate Code requirements. Larger counties such as Los Angeles do not accept schedules that do not comply with the Probate Code requirements; some smaller counties do.

California Rule of Court 7.902 requires the account and petition to state the names and last-known addresses of all vested or contingent beneficiaries (except those who need not be given notice under Prob C §15804; and for a revocable trust, only the person holding the power to revoke need be listed). Inasmuch as the rule requires both the account and the petition to list the beneficiaries, a separate schedule with this list should be added to the account. See §§7.54, 7.118.

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§7.75 a. Property on Hand at Beginning of Account

If there is a list of assets received from a predecessor trustee or from an executor, these items are included in the Property on Hand at Beginning of Account schedule. Include each item separately, rather than as a total. Except in special circumstances, the value of each asset when the trustee receives it is the appropriate fiduciary acquisition value (carry value). It is easier for the beneficiary to understand the accounting if there are two columns containing values, one for fiduciary acquisition value and one for market value. There can be two separate schedules, one showing the assets at carry value, the other the same assets at market value, particularly if the computer program the trustee is using, *e.g.,* Quicken, does not allow customizing an asset schedule. See Prob C §§1061(a)(1), 1063(a).

In the first account, initial assets can be listed in a schedule titled Receipts of Principal, especially if a great deal of time has elapsed between the last account of the former fiduciary and the date the trustee receives the assets. For these assets to be treated as received on the date the assets were said to have been distributed, the new trustee must account for activity that occurred before the trustee took possession of the assets or the account will not balance.

PRACTICE TIP: The former fiduciary should be asked to prepare a cash closing statement that discloses the income received and expenses incurred between the date of distribution and the time the successor trustee received the assets. If the cash received by the new trustee includes income that is to be distributed, the former fiduciary must provide an account that shows the allocation of receipts and disbursements between principal and income.

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§7.76 (1) Assets Received From Decedent

The carry value of assets received from a decedent would normally be the same value as that used by the executor for purposes of distribution. If there is no executor, the trustee uses the date-of-death values found on the estate tax return, if the values are close to the values of the assets when the trustee receives them. If no estate tax return was filed, but the death was recent, the trustee will value the assets as of the date of death. If the death occurred long before the trustee begins to serve, the assets are valued at the market value they have when they are received. Although this can be confusing because the carry value is not the same as the cost basis, it gives beneficiaries a more accurate picture of how the trust has fared under the trustee's administration.

The first account in a testamentary trust must reconcile the initial assets on hand with the decree of distribution of the estate. Cal Rules of Ct 7.901(b).

NOTE: Assets received in kind in satisfaction of a pecuniary gift should be carried at the values used for purposes of distribution. By accepting the distribution, the trustee in effect consents to the distributing fiduciary's valuation and should therefore be willing to account for the asset at the same value. It is also helpful for tracing purposes to use the distribution value.

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§7.77 (2) Assets Received From Settlor or Former Trustee

The carry value, unlike the cost basis, is the value the assets have at the time of receipt. The use of cost basis by a successor trustee on the schedule of property on hand at the beginning of the account period could give a misleading impression of the successor trustee's performance, especially if these values vary greatly from the values the assets had at the time of transfer to the successor trustee.

PRACTICE TIP: If applicable, the trustee should denote which assets are the separate property of the deceased settlor and which assets are the settlors' community property, because separate property assets may be allocated differently from community property assets in future subtrust funding.

Another problem successor trustees often encounter in preparing their first accounting is how to account for assets received long after the end of the accounting period in the former trustee's final account. The court examiners and tax return preparers need to know what happened in the interim. In such a case, the successor trustee has two choices:

- Put cash items, and any assets that have changed or been acquired since the end of the former trustee's last account, on a schedule titled Received from Former Trustee and have the former trustee prepare and file a cash closing statement; or
- List all the assets in the former trustee's schedule of property on hand at the end of the accounting period and account for any income or investment changes in his or her own account.

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§7.78 (3) Assets Purchased During Trust Administration

Carry values should include acquisition costs (purchase price plus commissions) to give a true picture of the cost of the investment to the fund. In the author's experience, most courts accept this method of presenting carry values, and these values are also used for capital gain or loss purposes on income tax returns.

If applicable, the trustee should denote whether the asset was purchased with separate or community property funds and accordingly has separate or community property character.

PRACTICE TIP: Check local rules, which might require broker's commissions to be listed separately.

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§7.79 (4) Adjustments to Carry Value of Beginning Assets

Adjust the carry value of any asset based on date-of-death values if an IRS tax audit adjusts the value. This provides consistency with the valuation of the other assets. The adjustment can be done on a separate schedule titled Adjustments to Carry Value of Beginning Assets following the beginning asset schedule; include an explanation of why the value was adjusted up or down.

PRACTICE TIP: Consider an adjustment carefully if the former trustee was using cost basis as the carry value. Revaluing the assets will require keeping two sets of records to calculate gain or loss, one for the accounting and one for the tax return preparer. Now that beginning market values are required to be shown in an account, the beneficiaries are able to track the current trustee's yearly investment performance without looking to the carry values to supply information.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.80 b. Form: Schedule: Beginning Assets

§7.80 b. Form: Schedule: Beginning Assets

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Beginning Assets
January 1, 2009-December 31, 2009

Description	*Date-of-Death Value 01/01/09*
Cash and Cash Equivalents:	
Small Town Bank, checking acct. 10101	100.00
Small Town Broker money market acct. 12345	5,000.00
Total Cash and Cash Equivalents:	5,100.00
Other Assets:	
Small Town Bank, CD 101 4% due 6/30/09	9,990.00
Accrued dividend on ABC stock payable 1/15/09	400.00
Accrued interest treasury note due 3/31/11	162.50
Uncashed interest check dated 12/31/09	20.00
100.324 shares MMM Mutual Fund acct. 67890	5,220.50
Small Town Broker acct. 12345:	
100 shares ABC Corp.	2,250.00
200 shares XYZ Corp.	1,800.00
300 pfd. shares DEF Corp. 6%	20,000.00
10,000 U.S. Treasury Bill due 2/1/11	8,500.00
10,000 U.S. Treasury Note 6.5% due 12/31/11	8,000.00
Small Town Bank IRA acct. No. 123	630,000.00
Personal Property:	
Furniture and furnishings at 100 Jones Street, Small Town, California*	24,500.00
2003 4-door Ford Taurus, model no. XXXX**	5,750.00
Real Estate:	
Single-family residence located at 100 Jones Street, Small Town, California***	875,000.00
2-unit building on large lot located at 1 Elm Street, Small Town, California****	1,050,000.00
Total Beginning Assets:	2,646,693.00

_____

*Appraisal dated 12/31/09 by AAA Appraisal Service
**Blue Book Value as of 12/31/09
***Estimated by Small Town Realty Service
****Appraisal done by AIA Service, Inc.

Doe Marital Trust
Schedule _ _[*letter*]_ _
Beginning Assets
January 1, 2010-December 31, 2010

Description	*Fiduciary Acquisition Value as of 01/01/10*
Cash	43,345.67
Small Town Bank IRA acct. 123:	637,000.00
50 shares ABC Corp.	1,250.00
Total Beginning Assets:	681,595.67

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Beginning Assets
January 1, 2010-December 31, 2010

Description	*Fiduciary Acquisition Value as of 01/01/10*
Cash	50.00
Rent owed by Jason Grey	700.00
50 shares ABC Corp.	1,250.00
10,000 U.S. Treasury Note 6.5% due 12/31/11	8,000.00
Single-family residence located at 100 Jones Street, Small Town, California encumbered by 50M Note at 5% fixed, secured by deed of trust held by California Small Town Bank, Small Town, due 2/1/18	900,000.00
Duplex at 1 Elm Street, Small Town, California	1,090,000.00
Total Beginning Assets:	2,000,000.00

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§7.81 c. Additional Assets Received

Assets received after the beginning of the accounting period should be listed in a subsequent receipts schedule. If the property is a change in form or a partial conversion of an initial asset, *e.g.,* a receipt of rights to subscribe for stock, it can be treated as an additional cash receipt (if the rights are sold shortly after receipt). Alternatively, the carry value of the stock can be reduced by the value of the rights. Either form is acceptable as long as the accounting method is consistently applied. If the property is a change in form, it should also be listed on a change in the form of assets schedule. See §7.104. On accounting for dividend reinvestment, see §7.42.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.82 d. Form: Schedule: Additional Assets Received

§7.82 d. Form: Schedule: Additional Assets Received

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Additions to Assets
January 1, 2009-December 31, 2009

Payor	*Description*	*Date Received*	*Amount*
Aetna Insurance Co.	Insurance refund	02/05/09	525.00
Rent owed by Jason Grey	Rent 9/1-12/31/09		1,600.00
Total Additions to Assets			2,125.00

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e. Receipts

§7.83 (1) Cash Items

Money received from an entity is allocated to income, unless it is received in a sale or liquidation or is a capital gain dividend from a regulated investment company or real estate investment trust for federal income tax purposes, in which case it is usually allocated to principal. Prob C §16350. Money received from an entity in partial liquidation is allocated to principal if the amount received by all owners collectively is greater than 20 percent of the entity's gross assets. Prob C §16350(d)(1). Money received from an entity also may be treated as received in partial liquidation if characterized as such in a contemporaneous statement by the entity's board of directors. Prob C §16350(e). See §8.16.

Other cash receipts are allocated between principal and income depending on the nature of the receipt. Items of a similar nature may not be combined under one entry, *e.g.*, interest paid, but must be listed separately by date and amount. For further discussion and a table specifying allocation of receipts between principal and income, see §§7.42-7.43.

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§7.84 (2) Noncash Items

Under Prob C §16350, all property received from an entity other than money must be allocated to principal. Under certain circumstances, money received in partial liquidation also may be allocated to principal. See §7.83. Although noncash distributions are often treated as partial liquidations of an original asset, the preferable method is to apportion the carry value of the original asset between the original and new asset at the ratio designated by the company, or if no ratio can be found, at the market value of the new asset on the date of distribution.

Common receipts of noncash items include:

- Spinoffs (see §7.85);
- Rights (see §7.86);
- Options (see §7.87); and
- Calls (see §7.88).

Some noncash items may also reflect a change in the form of assets that should be listed on the change in the form of assets schedule. See §7.104.

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§7.85 (a) Spinoffs

If the asset received is a spinoff from an asset held, the carry value should be allocated between the old and the new asset. The amount of allocation to each can be determined from the broker, the transfer agent, or the Internet site of the distributing company. These are better methods than using the market value of the spinoff as its carry value and adjusting the carry value of the original stock by the carry value of the stock spun off; in some cases, the latter approach can assign the original stock a negative carry value, an undesirable result.

PRACTICE TIP: If the trustee is prorating the value of the original asset among the original asset and the new assets, and the trustee is using a computer program for recordkeeping, it is easier to distribute the original asset from the list of investments at its carry value and receive the original asset (at its reduced carry value) and the new assets at the proportional values the trustee assigns.

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§7.86 (b) Rights

If the rights to subscribe are sold, the proceeds may be applied to reduce the carry value or may be treated as an additional receipt. However, the method used must be applied consistently. If the rights are exercised, the assets on hand at the end of the accounting period and the changes in the form of investments schedules should reflect the additional shares. The fiduciary acquisition value should not be changed unless the rights were assigned a value when received.

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§7.87 (c) Options

Options can be purchased as an investment. They can also be sold, they can expire, or they can be exercised. Each outcome is accounted for differently. If the options were purchased as an investment, they should be accounted for like any other investment when sold. If they expire, they should be treated as having been sold for zero dollars. If an option is exercised, the trustee can assign a carry value to the stock equal to its market price and show a gain on the option. However, the preferable approach is to combine the cost of the option with the purchase price for a total fiduciary acquisition value for the new asset, whether it is stock or real estate.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.88 (d) Calls

§7.88 (d) Calls

Calls are not viewed as assets, but as a hedging device. They can be sold and can produce a gain, which is treated as principal under Prob C §16355. If a covered call is sold and gain is realized, the carry value of the original stock should be reduced by the net proceeds from the sale of the call. If a call is exercised, the trustee records the sale of the stock at the exercise price, plus commissions. In order not to lose track of a call that has been sold (and therefore is not an asset), it can be carried at zero until it is "sold" for zero. The sale should also be noted on the schedule showing gains or losses on sales.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.89 f. Form: Schedule: Receipts

§7.89 f. Form: Schedule: Receipts

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Receipts
January 1, 2009-December 31, 2009

Description	*Date*	*Principal*	*Income*	*Amount*
Interest:				
Small Town Bank, checking acct. (C/A) 10101	01/31/09		4.00	4.00
Small Town Bank, C/A 10101	02/28/09		4.01	4.01
Small Town Bank, C/A 10101	03/29/09		4.02	4.02
Large Town Bank, C/A 999-99999	04/30/09		5.00	5.00
Large Town Bank, C/A 999-99999	05/31/09		5.02	5.02
Large Town Bank, C/A 999-99999	06/30/09		5.03	5.03
Large Town Bank, C/A 999-99999	07/31/09		200.00	200.00
Large Town Bank, C/A 999-99999	08/31/09		202.00	202.00
Large Town Bank, C/A 999-99999	09/31/09		204.00	204.00
Large Town Bank, C/A 999-99999	10/31/09		206.00	206.00
Large Town Bank, C/A 999-99999	11/30/09		100.00	100.00
Large Town Bank, C/A 999-99999	12/31/09		101.00	101.00
Small Town Bank, CD 10100 4% due 5/31/09	02/28/09		33.33	33.33
Small Town Bank, CD 10100 4% due 5/31/09	05/31/09		100.00	100.00
10M U.S. Treasury Note 6.5% due 12/31/11	03/31/09		162.50	162.50
10M U.S. Treasury Note 6.5% due 12/31/11	09/30/09		325.00	325.00

Total Interest:				1,660.91
Dividends:				
100 shares ABC Corp.	04/15/09		400.00	400.00
100 shares ABC Corp.	07/15/09		420.50	420.50
100 shares ABC Corp.	10/15/09		420.50	420.50
200 shares XYZ Corp.	03/31/09		120.00	120.00
300 DEF Corp. 6% pfd. A	02/28/09		500.00	500.00
300 DEF Corp. 6% pfd. A	05/30/09		500.00	500.00
300 DEF Corp. 6% pfd. A	08/31/09		500.00	500.00
100.324 shs MMM Mutual Fd acct. 67890	03/30/09		318.00	318.00
106.896 shs MMM Mutual Fd acct. 67890	06/30/09		325.00	325.00
Total Dividends:				3,504.00
Rent:				
1 Elm Street, Apt. A	01/02/09		200.00	200.00
1 Elm Street, Apt. B	01/02/09		225.00	225.00
1 Elm Street, Apt. A	02/02/09		200.00	200.00
1 Elm Street, Apt. B	02/02/09		225.00	225.00
1 Elm Street, Apt. A	03/02/09		200.00	200.00
1 Elm Street, Apt. B	03/03/09		225.00	225.00
1 Elm Street, Apt. A	04/02/09		200.00	200.00
1 Elm Street, Apt. B	04/15/09		225.00	225.00
1 Elm Street, Apt. A	05/02/09		200.00	200.00
1 Elm Street, Apt. B	05/06/09		225.00	225.00
1 Elm Street, Apt. A	06/02/09		200.00	200.00
1 Elm Street, Apt. B	06/02/09		225.00	225.00
1 Elm Street, Apt. A	07/02/09		200.00	200.00
1 Elm Street, Apt. B	07/20/09		225.00	400.00
1 Elm Street, Apt. A	08/02/09		200.00	200.00
1 Elm Street, Apt. B	08/31/09		225.00	400.00
1 Elm Street, Apt. A	09/02/09		200.00	200.00
1 Elm Street, Apt. A	10/02/09		200.00	200.00
1 Elm Street, Apt. A	11/02/09		200.00	200.00
1 Elm Street, Apt. A	12/02/09		200.00	200.00
Total Rent:				4,725.00
Other Receipts:				
Payment from BankAmerica IRA acct. 123	03/31/09	900.00	100.00	1,000.00

Security Deposit Apt. B, 1 Elm Street	05/31/09	400.00		400.00
Payment from BankAmerica IRA acct. 123	06/30/09	841.50	93.50	935.00
Payment from BankAmerica IRA acct. 123	09/30/09	792.00	88.00	880.00
Total Other Receipts:		2,933.50	271.50	3,215.00
Total Receipts:		2,933.50	10,171.41	13,104.91

Doe Marital Trust
Schedule _ _[*letter*]_ _
Receipts
January 1, 2010-December 31, 2010

Description	*Date*	*Amount*	*Totals*
Interest:			
Large Town Bank, C/A 999-99999	01/31/10	21.00	
Large Town Bank, C/A 999-99999	02/28/10	25.00	
Large Town Bank, C/A 999-99999	03/31/10	33.20	
Large Town Bank, C/A 999-99999	04/30/10	34.00	
Large Town Bank, C/A 999-99999	05/31/10	35.20	
Large Town Bank, C/A 999-99999	06/30/10	35.92	
Large Town Bank, C/A 999-99999	07/31/10	42.00	
Large Town Bank, C/A 999-99999	08/31/10	42.75	
Large Town Bank, C/A 999-99999	09/30/10	43.01	
Large Town Bank, C/A 999-99999	10/31/10	46.00	
Large Town Bank, C/A 999-99999	11/30/10	46.98	
Large Town Bank, C/A 999-99999	12/31/10	48.00	
10M U.S. Treasury note 6.5% due 12/31/11	06/31/10	325.00	
10M U.S. Treasury note 6.5% due 12/31/11	12/31/10	325.00	
Total Interest:			1,103.06
Dividends:			
50 shares ABC Corp.	01/15/10	200.00	
50 shares ABC Corp.	04/15/10	200.00	
50 shares ABC Corp.	07/15/10	210.25	
Total Dividends:			610.25
Receipts from IRA:			
Payment from BankAmerica IRA acct. 123	03/31/10	1,000.00	
Payment from BankAmerica IRA acct. 123	06/30/10	935.00	

Payment from BankAmerica IRA acct. 123	09/30/10	935.00	
Payment from BankAmerica IRA acct. 123	12/31/10	880.00	
Total IRA Receipts:			3,750.00
Total Cash Receipts:			5,463.31

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Receipts
January 1, 2010-December 31, 2010

Description	*Date*	*Principal Amount*	*Income Amount*	*Totals*
Interest:				
Large Town Bank, C/A 999-99999	01/31/10		21.00	
Large Town Bank, C/A 999-99999	02/28/10		25.00	
Large Town Bank, C/A 999-99999	03/31/10		33.20	
Large Town Bank, C/A 999-99999	04/30/10		34.00	
Large Town Bank, C/A 999-99999	05/31/10		35.20	
Large Town Bank, C/A 999-99999	06/30/10		35.92	
Large Town Bank, C/A 999-99999	07/31/10		42.00	
Large Town Bank, C/A 999-99999	08/31/10		42.75	
Large Town Bank, C/A 999-99999	09/30/10		43.01	
Large Town Bank, C/A 999-99999	10/31/10		146.00	
Large Town Bank, C/A 999-99999	11/30/10		246.98	
Large Town Bank, C/A 999-99999	12/31/10		148.00	
Total Interest:				853.06
Dividends:				
50 shares ABC Corp.	01/15/10		200.00	
50 shares ABC Corp.	04/15/10		210.05	
100 shares ABC Corp.	07/15/10		210.25	
100 shares ABC Corp.	10/15/10		210.25	
450 shares Vanguard Index Fund	09/30/10		520.00	

450 shares Vanguard Index Fund	12/31/10		560.00	
Total Dividends:				1,910.55
Capital Gain Distributions:				
450 shares Vanguard Index Fund	12/31/10	750.00		750.00
Total Receipts:		750.00	2,763.61	3,513.61

Comment: The above schedule shows asset activity during the year 2009, the year of the administrative trust, and provides a sample of a schedule for asset activity in the year 2010, the first year after the administrative trust has been allocated and distributed to the subtrusts.

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§7.90 g. Net Income or Loss From Trade or Business

If applicable, there must be a schedule showing net income or loss from a trade or business. Prob C §1062(c). It is sufficient for the accounting if the schedule provides the information disclosed on Schedule C or Schedule F of the Federal Fiduciary Income Tax Return.

NOTE: Under Prob C §16352(a), a trustee who conducts a business or other activity on behalf of the trust may keep separate records for its transactions, apart from the trust's general accounting records, if the trustee determines that it is in the best interest of all the beneficiaries to do so, whether or not its assets are separated from the other trust assets. Businesses for which the trustee may account separately include retail, manufacturing, service or other traditional businesses, farming, and managing rental properties. Prob C §16352(c).

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.91 h. Form: Schedule: Net Income or Loss From Trade or Business

§7.91 h. Form: Schedule: Net Income or Loss From Trade or Business

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Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Net Business Income
1 Elm Street Duplex
January 1, 2010-December 31, 2010

Payor/Payee	*Description*	*Date*	*Amount*	*Totals*
Income:				
1 Elm St., Apt. A	Rent	01/02/10	225.00	
1 Elm St., Apt. B	Rent	01/02/10	400.00	
1 Elm St., Apt. A	Rent	02/02/10	225.00	
1 Elm St., Apt. B	Rent	02/03/10	400.00	
1 Elm St., Apt. A	Rent	03/02/10	225.00	
1 Elm St., Apt. B	Rent	03/03/10	400.00	
1 Elm St., Apt. A	Rent	04/02/10	225.00	
1 Elm St., Apt. B	Rent	04/15/10	400.00	
1 Elm St., Apt. A	Rent	05/02/10	225.00	
1 Elm St., Apt. B	Rent	05/06/10	400.00	
1 Elm St., Apt. A	Rent	06/02/10	225.00	
1 Elm St., Apt. B	Rent	06/02/10	400.00	
1 Elm St., Apt. A	Rent	07/02/10	225.00	
1 Elm St., Apt. B	Rent	07/20/10	400.00	
1 Elm St., Apt. A	Rent	08/02/10	225.00	
1 Elm St., Apt. B	Rent	08/31/10	400.00	

1 Elm St., Apt. A	Rent	09/02/10	225.00	
1 Elm St., Apt. B	Rent	09/02/10	400.00	
1 Elm St., Apt. A	Rent	10/02/10	225.00	
1 Elm St., Apt. B	Rent	10/02/10	400.00	
1 Elm St., Apt. A	Rent	11/02/10	225.00	
1 Elm St., Apt. B	Rent	11/02/10	400.00	
1 Elm St., Apt. A	Rent	12/02/10	225.00	
1 Elm St., Apt. B	Rent	12/02/10	400.00	
Total Rental Income:				7,500.00
Receivable:				
Amt. owed by Jason Grey	Rent 9/1/09-12/31/09		700.00	700.00
Expenses:				
Small Town Property Mgmt.	Property management	01/31/10	(300.00)	
Small Town Plumbing Co.	New water heater	02/02/10	(250.00)	
Small Town Property Mgmt.	Property management	03/31/10	(300.00)	
Small County	Property tax	04/10/10	(450.00)	
Small Town Property Mgmt.	Property management	06/30/10	(300.00)	
ABC Painting Company	Paint unit B	07/02/10	(1,255.00)	
State Farm	Casualty Ins. 8/1/10-7/30/11	07/28/10	(590.00)	
Small Town Property Mgmt.	Property management	09/30/10	(300.00)	
Small Town Property Mgmt:	Property management	12/31/10	(300.00)	
Total Expenses:				(4,045.00)
Small Town Property Mgmt. Reserve for expenses:				(100.00)

Amount Distributed:	4,055.00

Comment: The above schedule shows asset activity during the year 2010, the first year after the administrative trust has allocated and distributed the property to the Doe Credit Shelter Trust.

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§7.92 i. Gains or Losses on Sales

Gains from any sales, tenders, or other dispositions during the accounting period must be shown. Although many local rules state that the court requires that losses be separately shown, in the author's experience the courts will accept a single schedule that shows both losses and gains. If the total gains and losses result in an overall gain, this figure is shown on a Gains on Sales schedule; if the total is a loss, it is shown on a Losses on Sales schedule. Showing gains and losses on the same schedule gives a better picture of how the trustee might have recognized losses to offset realized gains. See §7.35 regarding allocation of gain or loss to principal or income.

NOTE: If an asset is sold, disposed of, or exchanged and neither gain nor loss is realized, it is reported only on the schedule for Changes in Form of Assets. See §7.104.

PRACTICE TIP: For tax purposes, facts concerning related-party sales (where loss and capital gain treatment is not allowed) should be noted on the schedule. IRC §§267(b), 1239.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.93 j. Form: Schedule: Gain (Loss) on Sales

§7.93 j. Form: Schedule: Gain (Loss) on Sales

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Gain/Loss on Sales
January 1, 2009-December 31, 2009

Description	*Date Acquired*	*Date Sold/ Liquidated*	*Fiduciary Acquisition Value*	*Amount Received*	*Gain/Loss*
10,000 U.S. Treasury Bill due 2/1/09	01/02/09	02/02/09	8,500.00	10,000.00	1,500.00
Small Town Bank, CD 10100 4% 6/30/09	01/01/09	06/30/09	9,990.00	10,000.00	10.00
100.324 shares MMM Mutual Fund*	01/01/09	07/05/09	5,220.50	6,700.00	1,479.50
6.572 shares MMM Mutual Fund*	03/31/09	07/05/09	318.00	438.90	120.90
6.48 shares MMM Mutual Fund*	06/30/09	07/05/09	325.00	432.76	107.76
300 shares DEF Corp. 6% pfd. A	01/01/09	09/15/09	20,000.00	19,000.00	(1,000.00)
Total Gain on Sales:					2,218.16

Doe Marital Trust
Schedule _ _[*letter*]_ _
Gain/Loss on Sales
January 1, 2010-December 31, 2010

Description	*Date Acquired*	*Date Sold/ Liquidated*	*Fiduciary Acquisition Value*	*Amount Received*	*Gain/Loss*
50 shares ABC Corp.	01/01/10	07/01/10	1,250.00	1,200.00	(50.00)

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Gain/Loss on Sales
January 1, 2010-December 31, 2010

Description	*Date Acquired*	*Date Sold/ Liquidated*	*Fiduciary Acquisition*	*Amount Received*	*Gain/Loss*

			Value		
10,000 U.S. Treas. Nt 6.5% due 12/31/11	01/01/10	12/31/10	8,000.00	9,025.00	1,025.00

Comment: The above schedule shows asset activity during the year 2009, the year of the administrative trust, and provides a sample of a schedule for asset activity in the year 2010, the first year after the administrative trust has been allocated and distributed to the subtrusts.

NOTE: If assets are sold for cash, the dollar amount shown under "Amount Received" also appears on the Changes in Form of Assets schedule so that cash for the account will balance. See §§7.104-7.105.

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§7.94 k. Disbursements

As shown in the form in §7.95, the disbursement schedule should show the payee, the nature or purpose of each item, and the date of the transaction. The trustee should keep vouchers (proof of paid expenses, such as canceled checks or receipted bills; see §7.13) but not file them with the account.

Disbursements should be grouped in logical categories and fees should be clearly presented and explained. Disbursements that are allocated partly to principal and partly to income can either be broken down on the schedule itself (see §7.95) or the allocations can be shown on a separate information schedule called a Cash Summary (see §7.107). The cash summary should be used in any case if the computer program used (*e.g.,* Quicken) does not allow customization.

NOTE: Disbursements to beneficiaries are shown on a separate schedule titled Distributions.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.95 I. Form: Schedule: Disbursements

§7.95 I. Form: Schedule: Disbursements

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Disbursements
January 1, 2009-December 31, 2009

Payee	*Description*	*Date*	*Principal*	*Income*	*Totals*
Administration Expenses:					
Allright Attorney	Expenses advanced	02/02/09		325.00	325.00
Allright Attorney	Atty fee per court order	03/01/09	1,200.00	1,200.00	2,400.00
True Blue Trustee	Trustee fees 1st qtr.	04/15/09	250.00	250.00	500.00
True Blue Trustee	Trustee fees 2nd qtr.	07/15/09	251.50	251.50	503.00
True Blue Trustee	Trustee fees 3rd qtr.	10/15/09	252.50	252.50	505.00
Total Administration Expenses:					4,233.00
Funeral Expenses:					
Neptune Society	Cremation services	02/01/09	900.00		900.00
Flora's Flowers	Memorial service	02/01/09	150.00		150.00
Total Funeral Expenses:					1,050.00
Rental Expenses:					
Small Plumbing Co.	New water heater	02/01/09		250.00	250.00
ABC Painting Co.	Paint unit B	07/01/09	1,255.00		1,255.00
Small County	1st installment prop tax	04/10/09		450.00	450.00
State Farm	Ins 8/1/06-11/30/06	07/28/09		890.00	890.00
Total Rental Expenses:			1,255.00	1,590.00	2,845.00
100 Jones Street:					
State Farm	Policy #1256 thru 1/31/10	04/10/09		500.00	500.00

Small Town Bank	Mortgage payment	01/15/09	11.10	421.90	433.00
Small Town Bank	Mortgage payment	02/01/09	11.20	421.80	433.00
Small Town Bank	Mortgage payment	03/01/09	11.30	421.70	433.00
Small Town Bank	Mortgage payment	04/01/09	11.40	421.60	433.00
Small County	Property tax Jones St.	04/10/09		220.00	220.00
Small Town Bank	Mortgage payment	05/01/09	11.51	421.49	433.00
Small Town Bank	Mortgage payment	06/01/09	11.61	421.39	433.00
Small Town Bank	Mortgage payment	07/01/09	11.72	421.28	433.00
Small Town Bank	Mortgage payment	08/01/09	11.82	421.18	433.00
Small Town Bank	Mortgage payment	09/01/09	11.93	421.07	433.00
Small Town Bank	Mortgage payment	10/01/09	12.02	420.98	433.00
Small Town Bank	Mortgage payment	11/01/09	12.13	420.87	433.00
Small Town Bank	Mortgage payment	12/01/09	12.25	420.75	433.00
Small County	Property tax Jones St.	12/10/09		220.00	220.00
Total Jones Street Disbursements:			139.99	5,996.01	6,136.00
Taxes:					
IRS	2008 income tax	04/15/09	650.00		650.00
Franchise Tax Bd.	2008 income tax	04/15/09	225.00		225.00
IRS	1st qtr. est. tax 2009	04/15/09	150.00		150.00
Franchise Tax Bd.	1st qtr. est. tax 2009	04/15/09	150.00		150.00
IRS	2d qtr. est. tax 2009	06/15/09	150.00		150.00
Franchise Tax Bd.	2d qtr. est. tax 2009	06/15/09	150.00		150.00
IRS	3d qtr. est. tax 2009	09/15/09	150.00		150.00
Franchise Tax Bd.	3d qtr. est. tax 2009	09/15/09	150.00		150.00
Total Taxes:					1775.00
Total Disbursements:			6,173.99	9,865.01	16,039.00

Doe Marital Trust
Schedule _ _[*letter*]_ _
Disbursements
January 1, 2010-December 31, 2010

Payee	*Description*	*Date*	*Amount*	*Totals*
House-Related Expenses:				
State Farm	Pol. #1256 thru 1/31/10	01/31/10	500.00	
Small Town Bank	Mortgage Payment	01/31/10	433.00	
Small Town Bank	Mortgage Payment	02/01/10	433.00	
Small Town Bank	Mortgage Payment	03/01/10	433.00	
Small Town Bank	Mortgage Payment	04/01/10	433.00	
Small County	Property Tax	04/01/10	220.00	
Small Town Bank	Mortgage Payment	05/01/10	433.00	
Small Town Bank	Mortgage Payment	06/01/10	433.00	
Small Town Bank	Mortgage Payment	07/01/10	433.00	
Small Town Bank	Mortgage Payment	08/01/10	433.00	
Small Town Bank	Mortgage Payment	09/01/10	433.00	
Small Town Bank	Mortgage Payment	10/01/10	433.00	
Small Town Bank	Mortgage Payment	11/01/10	433.00	
Small Town Bank	Mortgage Payment	12/01/10	433.00	
Small County	Property Tax	12/10/10	220.00	
Total House-Related Expenses:				6,136.00
Taxes:				
IRS	2009 income tax	04/15/10	650.00	
Franchise Tax Board	2009 income tax	04/15/10	225.00	
IRS	1st qtr. est. tax 2010	04/15/10	150.00	
Franchise Tax Board	1st qtr. est. tax 2010	04/15/10	150.00	
IRS	2nd qtr. est. tax 2010	06/15/10	150.00	
Franchise Tax Board	2nd qtr. est. tax 2010	06/15/10	150.00	
IRS	3rd qtr. est. tax 2010	09/15/10	150.00	
Franchise Tax Board	3rd qtr. est. tax 2010	09/15/10	150.00	
Total Taxes:				1,775.00
Total Disbursements:				7,911.00

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Disbursements
January 1, 2010-December 31, 2010

Payee	*Description*	*Date*	*Principal*	*Income*	*Totals*

True Blue Trustee	Trustee fees 1st qtr.	04/15/10	150.00	150.00	300.00
Certified Accountants	Accounting fees	05/01/10	500.00	500.00	1,000.00
True Blue Trustee	Trustee fees 2nd qtr.	07/15/10	155.00	155.00	310.00
True Blue Trustee	Trustee fees 3rd qtr.	10/15/10	156.00	156.00	312.00
Total Disbursements:			961.00	961.00	1,922.00

Comment: The above schedule shows asset activity during the year 2009, the year of the administrative trust, and provides a sample of a schedule for asset activity in the year 2010, the first year after the administrative trust has been allocated and distributed to the subtrusts.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.96 m. Distributions: Specific Devises, Cash, and Assets

§7.96 m. Distributions: Specific Devises, Cash, and Assets

If a trust will be distributed to an income beneficiary, there must be a schedule showing an allocation of receipts and disbursements between principal and income. Prob C §1063(c); Cal Rules of Ct 7.901(c). A distribution of cash or property must show the date and amount of each with the distribution shown at its carry value. Prob C §1062(e).

In a net income trust, distributions of cash must be accounted for separately from distributions of assets; otherwise it will be difficult to produce a cash summary schedule with amounts referring to the totals appearing on individual schedules. As the time limit for distributing specific devises without paying interest approaches, many trustees distribute the specific devises before final distribution. If that is done, the devises will appear in the account as distributions and should be entered on a separate schedule. If court approval is sought before distribution, the specific devises should be listed on a proposed distribution schedule as a separate category.

PRACTICE TIP: If a distribution is made under the IRC §663(b) 65-day rule for the prior tax year, it will be helpful for tax purposes to note this on the accounting schedule.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.97 n. Form: Schedule: Distributions of Specific Devises, Cash, and Assets

§7.97 n. Form: Schedule: Distributions of Specific Devises, Cash, and Assets

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1. Distribution of Specific Devises

Doe Administrative Trust
Schedule _ _[*letter*]_ _
Specific Devises
January 1, 2009-December 31, 2009

Distributions	*Date of Distribution*	*Cash Value*	*Asset Value*	*Totals*
Under Doe Family Trust Art 2:				
Jane Doe:				
Furniture and furnishings at 100 Jones Street, Small Town, California	04/01/09		24,500.00	
2001 4-door Ford Taurus, model no. XXXX	04/01/09		5,750.00	
Total Distributed to Jane Doe:				30,250.00
Under Doe Family Trust Art 3(a):				
Lancelot Doe:				
200 shares XYZ Corp.	05/01/09		1,800.00	
XYZ Corp. $120 dividend (see distributions)	03/31/09	120.00		
Total Distributed to Lancelot Doe:		120.00	1,800.00	1,920.00
Total Specific Devises:				32,170.00

2. Cash Distributions

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Cash Distributions
January 1, 2010-December 31, 2010

Payee	*Description*	*Date*	*Amount*	*Totals*
Jane Doe	Est. income	04/15/10	1,000.00	
Jane Doe	Est. income	07/15/10	1,000.00	
Jane Doe	Est. income	10/15/10	1,000.00	
Total Cash Distributions:				3,000.00

3. Distribution of Assets

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Asset Distributions
January 1, 2010-December 31, 2010

Distributee:	*Description*	*Date*	*Amount*	*Totals*
Small Town Property Mgmt.	Grey receivable	01/01/10	700.00	700.00

Comment: The above schedule shows asset activity during the year 2009, the year of the administrative trust, and provides a sample of a schedule for asset activity in the year 2010, the first year after the administrative trust has been allocated and distributed to the subtrusts.

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§7.98 o. Property on Hand at End of Account

The schedule of property on hand lists the current trust assets for which the trustee accepts responsibility as comprising all of the assets of the trust. If ownership of some assets is in question, *e.g.,* because of a quiet title action, the trustee should note this fact for the information of the court. By placing an asset on this schedule, the trustee is acknowledging responsibility for its management and for collection of income due on it. Each item should be listed at its carry value. Prob C §1062(f).

The sample schedule of property on hand in §7.99 provides information in a logical format. In addition to the required information, it provides information that may be of interest to the court or beneficiaries, such as projected annual income.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.99 p. Form: Schedule: Ending Assets

§7.99 p. Form: Schedule: Ending Assets

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Ending Assets as of December 31, 2009

Description	*Market Value*	*Fiduciary Acquisition Value*
Cash and Cash Equivalents:		
Large Town Bank, C/A (checking acct.) 999-9999	500.00	500.00
Large Town Broker Money Market Account	48,582.07	48,582.07
Total Cash and Cash Equivalents		49,082.07
Securities:		
Large Town Broker acct. 67890:		
100 shares ABC Corp	2,500.00	2,250.00
10,000 U.S. Treasury Note 6.5%, due 12/31/11	8,700.00	8,000.00
Individual Retirement Account:		
Small Town Bank IRA acct. No. 123	637,000	630,000
Receivable:		
Rent owed by Jason Grey	700.00	1,600.00
Real Estate:		
Single-family residence located at 100 Jones Street, Small Town, California	900,000.00	875,000.00
Duplex located at 1 Elm Street, Small Town, California	1,090,000.00	1,050,000.00
Total Noncash Assets:	2,638,900.00	2,566,850.00
Total Assets:	2,687,982.07	2,615,932.07

Doe Marital Trust
Schedule _ _[*letter*]_ _
Ending Assets as of December 31, 2010

Description	*Market Value*	*Fiduciary Acquisition Value*
Large Town Money Market acct. 456	42,097.98	42,097.98
Small Town Bank IRA acct. 123	640,000.00	637,000.00
Total Assets:	682,097.98	679,097.98

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Ending Assets as of December 31, 2010

Description	*Market Value*	*Fiduciary Acquisition Value*
C/A 123 Large Town Bank	4,221.61	4,221.61
ABC Corp.	1,275.00	1,250.00
Vanguard Index Fund	8,001.00	7,500.00
Single-family residence located at 100 Jones Street, Small Town, California	900,000.00	900,000.00
Rental Business: Duplex at 1 Elm Street, Small Town, California	1,154,000.00	1,090,000.00
Total Assets:	2,067,497.61	2,002,971.61

Comment: The above schedule shows asset activity during the year 2009, the year of the administrative trust, and provides a sample of a schedule for asset activity in the year 2010, the first year after the administrative trust has been allocated and distributed to the subtrusts.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.100 3. Additional Required Schedules

§7.100 3. Additional Required Schedules

In addition to the schedules required under Prob C §1062 (see §§7.74-7.99), the following schedules are required under Prob C §1063 (see §§7.101-7.111):

- Estimated market value of assets as of the end of the accounting period;
- Purchases or other changes in the form of assets;
- Allocation of receipts and disbursements between principal and income if distributions are to be made to an income beneficiary;
- Income, disbursements, and proceeds of sale of specifically devised property;
- Interest on gifts and devises under Prob C §12003, §12004, 12005, or §16340(b);
- Proposed distributions, including allocation of income and valuation of assets; and
- Liabilities, if any, at the end of the accounting period, including liens, taxes due but unpaid, notes payable, and judgments.

These additional schedules, which are discussed in §§7.101-7.111, are not part of the Summary of Account that is part of the body of the text of the court petition.

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§7.101 a. Market Values of Assets at Beginning and End of Accounting Period

Under Prob C §1063(a), an additional schedule must be provided in all accounts showing the estimated market value of the assets on hand as of the end of the accounting period, and a schedule of assets on hand as of the beginning of the accounting period for all accounts after the initial account. Many courts do not require entire separate schedules and will accept a separate column on the schedule of beginning assets and a separate column on the schedule of property on hand at the end of the accounting period showing market values for these dates. See §7.99. This is good idea unless the computer program being used does not allow customization, in which case clearly labeled separate schedules should be used.

The value of real estate, a closely held business, or other assets without a "ready" market must be estimated in good faith by the trustee, as should other assets that are difficult or expensive to value on a periodic basis. Prob C §1063(a). A notation of how the trustee arrived at the value should be included in the schedule.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.102 b. Liabilities at End of Accounting Period

§7.102 b. Liabilities at End of Accounting Period

If at the end of the accounting period there are liabilities of the trust other than current or future periodic payments, including rent, salaries, utilities, or other recurring expenses, a schedule of the trust's liabilities must be provided showing the following (Prob C §1063(g)):

- Liabilities that are a lien on the trust assets;
- Taxes due but unpaid as shown on filed returns or assessments received after filing returns;
- All notes payable;
- Judgments for which the trust is liable; and
- Other material liabilities.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.103 c. Form: Schedule: Liabilities

§7.103 c. Form: Schedule: Liabilities

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Liabilities
January 1, 2009-December 31, 2009

Description	*Amount Owing End of Period*
50M Note at 5% fixed secured by deed of trust on 100 Jones Street, Small Town, California, held by Small Town Bank, Small Town, California, due 2/1/18	35,000.00
Less principal payments made on note (Schedule _ _[*letter*]_ _):	-139.99
Balance of Mortgage:	34,860.01
Income Tax for return due 4/15/2009	800.00
Tax Preparation Fee for return due 2009	500.00
Frank Navarro, Esq. to evict Jason Grey; estimated contingency fee due when back rent is collected	400.00
Total Liabilities:	71,420.02

Doe Marital Trust
Schedule _ _[*letter*]_ _
Liabilities
January 1, 2010-December 31, 2010

Description	*Amount Owing End of Period*
50M Note at 5% fixed secured by deed of trust on 100 Jones Street, Small Town, California, held by Small Town Bank, Small Town, California, due 2/1/18	34,801.00

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Liabilities
January 1, 2010-December 31, 2010

Description	*Amount Owing End of Period*
To Jane Doe: Accumulated income as of 12/31/10	2,857.61

Comment: The above schedule shows asset activity during the year 2009, the year of the administrative trust, and provides a sample of a schedule for asset activity in the year 2010, the first year after the administrative trust has been allocated and distributed to the subtrusts.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.104 d. Changes in Form of Assets

§7.104 d. Changes in Form of Assets

A schedule of purchases or other changes in the form of assets during the period of the account is required for all applicable accountings. Prob C §1063(b). This schedule also shows all amounts of cash realized by the sale or maturity of assets.

Although some jurisdictions prefer broker's commissions to be listed separately in the schedule of disbursements, if allowable, the broker's commission should be included in the purchase and sales price, *i.e.,* net figures used in the account. Using a form that shows only net figures, which is useful to calculate gains and losses for income tax return purposes, should be weighed against the Prob C §16050 requirement that trustees consider costs in making investments. If the commissions are high or the volume of purchases and sales is unusually high, the account preparer should consider stating commissions separately on a disbursement schedule so that these costs are not hidden in net figures.

No reporting is required for transfers between uninvested cash or accounts in a financial institution or money market mutual fund. Prob C §1063(b). Some local rules provide that the court will not accept accountings containing such transfers.

NOTE: Even if the trustee is not precluded from including transfers between accounts, they are confusing to beneficiaries and should not be included in a normal accounting.

All changes that are not reflected in other schedules should appear in this schedule. Common entries are receipt of stock splits, spinoffs of shares in a new company from an existing company, and reinvestment of dividends for the purchase of additional shares of stock.

PRACTICE TIP: The trustee should carefully examine disposition of assets to make sure any resulting asset remains on the books of the trust; *e.g.*, when a note and deed of trust are taken back by the trust after the sale of real property, both the note and the beneficial interest under the deed of trust should be listed as trust assets. See *Heaps v Heaps* (2004) 124 CA4th 286, 21 CR3d 239 (deed of trust resulting from sale of trust asset was determined to be a trust asset regardless of title on the deed of trust).

The totals from this schedule are used in the cash summary schedule for net income trusts. If net income must be calculated, any assets converted to cash during the accounting period should be shown on this schedule, or the cash summary schedule will not balance to the ending cash.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.105 e. Form: Schedule: Changes in Form of Assets

§7.105 e. Form: Schedule: Changes in Form of Assets

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Changes in Form of Assets
January 1, 2009-December 31, 2009

Description	*Date*	*Amount*
Sales:		
300 shares DEF Corp. 6% pfd. A	09/15/09	19,000.00
100.324 shares MMM Mutual Fund	07/05/09	6,700.00
6.572 shares MMM Mutual Fund*	07/05/09	438.90
6.48 shares MMM Mutual Fund*	07/05/09	432.76
Total Sales:		26,571.66
Maturities:		
10,000 U.S. Treasury Bill due 2/1/09	02/01/09	10,000.00
10,000 Small Town Bank, CD 10100 4% due 6/30/09	06/30/09	10,000.00
Total Maturities:		20,000.00
Other Principal Receipts:		
Accrued div on ABC stock payable 1/15/09	01/15/09	400.00
Accrued int treasury note due 2/1/11	02/01/09	162.50
Uncashed interest check dated 12/31/2008	01/20/09	20.00
Internal Revenue Service, 2008 tax refund	05/25/09	175.00
Aetna Insurance Company, insurance refund	02/05/09	350.00
Total Other Principal Receipts:		1,107.50
Total Principal Receipts:		47,679.16
Purchases:		
6.572 shares MMM Mutual Fund acct. 67890	03/30/09	318.00
6.48 shares MMM Mutual Fund acct. 67890	06/30/09	325.00
Total Purchases:		643.00
Other Changes in Assets:		
Closed Account: Small Town Bank, checking acct. 10101	03/29/09	
Opened Account: Large Town Bank, checking acct. 999-9999	03/29/09	

Doe Marital Trust
Schedule _ _[*letter*]_ _
Changes in Assets
January 1, 2010-December 31, 2010

Sales:

Description	*Sold/ Liquidated*	*Sales Price*
50 shares ABC Corp.	07/20/10	1200.00

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Changes in Assets
January 1, 2010-December 31, 2010

Sales:

Description	*Sold/ Liquidated*	*Sales Price*
10,000 U.S. Treasury note 6.5% due 12/31/11	01/31/10	9,025.00

Purchases:

Description	*Purchased*	*Purchase Price*
450 shares Vanguard Index Fund	08/15/10	7,500.00

Other Changes in Assets:

Received 50 shares ABC, 2 for 1 stock split	08/01/10

Comment: The above schedule shows asset activity during the year 2009, the year of the administrative trust, and provides a sample of a schedule for asset activity in the year 2010, the first year after the administrative trust has been allocated and distributed to the subtrusts.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.106 f. Net Income Trust Cash Summary

§7.106 f. Net Income Trust Cash Summary

A schedule showing allocation of receipts and disbursements between principal and income is needed in at least two common cases:

- If assets will be distributed to an income beneficiary, such as on distribution of a decedent's estate or on termination of one life interest and the beginning of another (see Prob C §1063(c)); and
- If the trust designates one or more beneficiaries as the recipient(s) of net income.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.107 g. Form: Schedule: Cash Summary

§7.107 g. Form: Schedule: Cash Summary

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Cash Summary
January 1, 2009-December 31, 2009

Description	*Principal*	*Income*	*Totals*
Beginning Cash (Schedule _ _[*letter*]_ _):	5,100.00		5,100.00
Cash Receipts (Schedule _ _[*letter*]_ _):	2,933.50	10,171.41	13,104.91
Disbursements (Schedule _ _[*letter*]_ _):	(6,173.99)	(9,865.01)	(16,039.00)
Specific Devises (Schedule _ _[*letter*]_ _):		(120.00)	(120.00)
Sales (Schedule _ _[*letter*]_ _):	26,571.66		26,571.66
Maturities (Schedule _ _[*letter*]_ _):	20,000.00		20,000,00
Other Principal Receipts (Schedule _ _[*letter*]_ _):	1,107.50		1,107.50
Purchases (Schedule _ _[*letter*]_ _):	(643.00)		(643.00)
Ending Cash (Schedule _ _[*letter*]_ _):	48,895.67	186.40	49,082.07

Not Applicable to Doe Marital Trust

Doe Credit Shelter Trust
Schedule _ _[*letter*]_ _
Cash Summary
January 1, 2010-December 31, 2010

Description	*Principal*	*Income*	*Totals*
Beginning Cash (Schedule _ _[*letter*]_ _):	50.00		50.00
Receipts (Schedule _ _[*letter*]_ _):	750.00	2,763.61	3,513.61
Net Business Income (Schedule _ _[*letter*]_ _):		4.055.00	4,055.00
Disbursements (Schedule _ _[*letter*]_ _):	(961.00)	(961.00)	(1,922.00)
Cash Distributions (Schedule _ _[*letter*]_ _):		(3,000.00)	(3,000.00)

Sales Proceeds (Schedule _ _[*letter*]_ _):	9,025.00		9,025.00
Purchases (Schedule _ _[*letter*]_ _):	(7,500.00)	_____	(7,500.00)
Ending Cash:	1,364.00	2,857.61	4,221.61

Comment: The above schedule shows asset activity during the year 2009, the year of the administrative trust, and provides a sample of a schedule for asset activity in the year 2010, the first year after the administrative trust has been allocated and distributed to the subtrusts.

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§7.108 h. Specifically Devised Property

If there is specifically devised property, a schedule is required showing income, disbursements, and proceeds of sale relating to the specific gift or devise, in accordance with Prob C §§12002 and 16340(a), along with any interest attributable to the specific gift or devise. Prob C §1063(d).

PRACTICE TIP: It is a good idea for the attorney to ask the trustee or the trustee's agent to keep a record of income and expenditures relating to a specific gift or devise at the start of the recordkeeping process to save time, effort, and expense later.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.109 i. Interest Calculations for Distributions

§7.109 i. Interest Calculations for Distributions

If a right to distribution bears interest, Prob C §1063(e) requires a schedule showing how the interest is calculated. The interest should be shown in a separate column on the distribution schedule. See §7.97.

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§7.110 j. Proposed Distributions

If the accounting contemplates a proposed distribution, a schedule is required showing the proposed distribution including, if applicable, allocation of income required under Prob C §12006, allocation between trusts, and date-of-distribution valuations. Prob C §1063(f).

PRACTICE TIP: Although the trustee often makes distributions from the trust before an accounting and then includes them in the final accounting on the schedule of distributions, it may be wise to delay certain distributions until they can be presented on a schedule of proposed distributions as part of an accounting. This is particularly true if the trustee anticipates an objection. The distributions can then be made after the accounting is approved. See §7.111.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.111 k. Form: Schedule: Proposed Distributions

§7.111 k. Form: Schedule: Proposed Distributions

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Doe Administrative Trust
Schedule _ _[*letter*]_ _
Proposed Distributions
January 1, 2009-December 31, 2009

Distributions	*Cost or Date-of-Death Value*	*Date of Distribution Value 12/31/09*
Cash:		
Cash on hand at date of distribution:	48,582.07	48,582.07
Less accumulated income:	-186.40	-186.40
Less reserve for fees and closing costs:	-5,000.00	-5,000.00
Cash available for distribution:	43,395.67	43,395.67
Securities:		
Large Town Broker acct. 67890:		
100 shares ABC Corp.	2,250.00	2,500.00
10M U.S. Treasury note 6.5% due 12/31/11	8,700.00	8,000.00
Individual Retirement Account:		
Small Town Bank IRA acct. No. 123	630,000.00	637,000.00
Receivable:		
Rent owed by Jason Grey	700.00	700.00
Real Estate:		
Single-family residence located at 100 Jones St., Small Town, CA Encumbered by 50M note at 5% fixed, secured by deed of trust held by California Small Town Bank, Small Town, due 2/1/18	875,000.00	900,000.00
Duplex located at 1 Elm Street, Small Town, CA	1,050,000.00	1,090,000.00
Total To Be Distributed:	2,610,045.67	2,681,595.67
To:		
DOE MARITAL TRUST		
Cash	43,345.67	43,345.67
Small Town Bank IRA acct. 123	630,000.00	637,000.00
50 shares ABC Corp.	900.00	1,250.00

	674,245.67	681,595.67
To:		
DOE CREDIT SHELTER TRUST:		
Cash	50.00	50.00
Rent owed by Jason Grey	1,600.00	700.00
50 shares ABC Corp.	900.00	1,250.00
10,000 U.S. Treasury Note 6.5% due 12/31/11	8,000.00	8,000.00
Single-family residence located at 100 Jones St., Small Town, CA Encumbered by 50M note at 5% fixed, secured by deed of trust held by California Small Town Bank, Small Town, due 2/1/18	875,000.00	900,000.00
Duplex at 1 Elm Street, Small Town, CA	1,050,000.00	1,090,000.00
	1,935,550.00	2,000,000.00

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D. Petition for Settlement of Account

§7.112 1. Required Contents of Petition

Under Prob C §1064(a), the petition for court approval of an account must contain all of the following:

- A description of all sales, purchases, changes in the form of assets, or other transactions occurring during the period of the account that are not otherwise readily understandable from the schedule;
- An explanation of any unusual items appearing in the account;
- A statement of all compensation paid from the assets subject to the account to the fiduciary or to the attorneys for the fiduciary other than under a prior court order;
- A statement disclosing any family or affiliate relationship between the fiduciary and any agent hired by the fiduciary during the accounting period; and
- An allegation disclosing whether all the cash has been invested and maintained in interest-bearing accounts or in investments authorized by law or the governing instrument, except for an amount of cash that is reasonably necessary for the orderly administration of the estate.

The trustee's authority to bring a petition "[s]ettling the accounts and passing upon the acts of the trustee, including the exercise of fiduciary powers" is contained in Prob C §17200(b)(5).

CAUTION: Filing the petition gives the probate court general jurisdiction over the trust. See §7.56B.

California Rules of Court 7.902 requires the petition and account to state the names and last-known addresses of all vested or contingent beneficiaries (except for those who need not be given notice under Prob C §15804; and for a revocable trust only the person holding the power to revoke need be listed). Inasmuch as the rule requires both the account and the petition to list the beneficiaries, a separate schedule with this list should be added to the account. See §§7.54, 7.118.

If compensation of a trustee will be requested, see Cal Rules of Ct 7.776 for factors the court may consider. See also chap 9. If a request for attorney fees will include paralegal fees for extraordinary services, a declaration setting forth the information requested in Cal Rules of Ct 7.703 should be attached.

The form of papers must comply with Cal Rules of Ct 2.100-2.119.

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§7.113 a. Consulting Local Rules for Account

While a court account must contain the information set forth in Prob C §1061(a) and the summary must be in a format substantially the same as that specified in Prob C §1061(b) (see §7.71), practitioners should consult local rules to determine whether a particular format is required in the presentation of the information. For example, some counties may require certain titles for the categories in the required summary and assign specific schedule letters to each category. Some counties, in their local rules, may require an additional summary sheet, *e.g.,* if attorney fees or trustee compensation is being requested. The county may have its own form that must be used for this additional summary sheet. Some counties may require that the information in the schedules be presented in chronological order.

There may be other local rules regarding information that must be included in the petition for settlement of account, *e.g.,* about fee requests.

PRACTICE TIP: The attorney planning to file an accounting in an unfamiliar jurisdiction might also consult the clerk of the court or probate commissioner about any unwritten rules.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.114 b. Form: Trustee's Petition for Settlement of Account and Approval of Compensation and Fees

§7.114 b. Form: Trustee's Petition for Settlement of Account and Approval of Compensation and Fees

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In re Trust created under the Will of _ _[*name of decedent*]**_ _, deceased** [*Or*] **In re _ _**[*name*]**_ _ Trust, Established under _ _**[*Declaration of Trust/Trust Agreement*]**_ _ dated _ _**[*date*]**_ _** **———————————**	**No. _ _ _ _ _ _** **PETITION FOR SETTLEMENT OF ACCOUNT AND APPROVAL OF TRUSTEE AND ATTORNEY FEES (PROBATE CODE §17200(b)(5), (b)(9))** **Hearing: _ _**[*date*]**_ _** **Time: _ _**[*time*]**_ _** **Dep't: _ _**[*number*]**_ _**

Petitioner _ _[*name*]**_ _, the Trustee (hereafter referred to as "Petitioner") of the Trust under the _ _**[*Will of _ _*[*name*]*_ _, deceased, and the decree of distribution of decedent's estate/Declaration of Trust/Trust Agreement created by _ _*[*name*]*_ _ on _ _*[*date*]*_ _*]**_ _, hereby presents the _ _**[*e.g., first*]**_ _ account and report of the administration of the Trust, covering the period from _ _**[*date*]**_ _, to _ _**[*date*]**_ _. Petitioner respectfully shows:**

1. Jurisdiction and Venue:

[*If trust is not under continuing court jurisdiction (see §7.70), include allegations demonstrating the existence of the trust, e.g., the following*]

The _ _[*Name*]**_ _ Family Trust was established by _ _**[*name*]**_ _ (Decedent) and Petitioner as Settlors and Cotrustees, pursuant to the Declaration of Trust dated _ _**[*date*]**_ _ (Trust Instrument). Attached to this Petition are true and correct copies of the Trust Instrument with the following redactions: _ _**[*list portions omitted, if any, and reasons for omission, e.g., to keep certain family matters private*]**_ _. Decedent died on _ _**[*date*]**_ _, at which time, under the terms of the Trust Instrument, the _ _**[*name*]**_ _ Family Trust terminated and the _ _**[*name*]**_ _ Family Administrative Trust came into existence. On _ _**[*date*]**_ _, the _ _**[*name*]**_ _ Family Administrative Trust was distributed in full to the following subtrusts created under the terms of the Trust Instrument: _ _**[*names and descriptions of subtrusts*]**_ _. As used in this Petition, the term "Trust" collectively refers to the _ _**[*name*]**_ _ Family Administrative Trust and all subtrusts created under the Trust Instrument following Decedent's death. Petitioner, as initial cotrustee of the _ _**[*name*]**_ _ Family Trust has remained the sole trustee of all trusts created under the Trust Instrument.**

[*Continue*]

The Trust is administered in _ _[*name*]**_ _ County, California.**

[*Add the following paragraph if trust is not under continuing court jurisdiction (see Prob C §17202)*]

2. Necessity of Petition:

This Petition is reasonably necessary for the protection of the interests of _ _[*the Trustee/the beneficiaries/both the Trustee and the beneficiaries*]**_ _ because _ _**[*e.g., one or more beneficiaries have raised several questions regarding the Trustee's administration of the Trust. Without approval of the Court as to the account, the Trustee would be required to hold back substantial funds from distribution to the beneficiaries in order to cover potential costs of litigating any claims made during the approximately three years until the statute of limitations has expired. By means of*

this Petition, the Trustee seeks timely determination of all matters presented in this account so that other beneficiaries may continue to receive ongoing distributions without lengthy delay.]_ _

[*Continue*]

[3.] Summary of Account:

Petitioner should be charged and credited as shown in the following Summary of Account supported by the schedules referred to, which are incorporated here by reference:

_ _[*Insert Summary of Account*]_ _.

[4.] Beneficiaries:

Pursuant to Probate Code §§15800-15804, 17203 and California Rules of Court 7.902, the name and mailing address of each beneficiary of the Trust entitled to notice, so far as known to Petitioner after diligent inquiry, _ _[*all of whom are over 18 years of age,*]_ _ **are as follows:**

[*List name, address, relationship to settlor, and age of each beneficiary*]

[*If representative interests are used (see §7.65C), add the following, as applicable*]

Petitioner is informed and believes that the beneficiaries named in Paragraph 4 constitute all beneficiaries of the Trust entitled to notice; that all indispensable parties have been listed; that sufficient identity exists between the interests of any person (Representative Beneficiary) virtually representing any future contingent or remainder beneficiary, whether living, unborn, a minor, potentially or actually incapacitated, unascertained, whose identity or address is unknown, or a member of a designated class of persons who are not ascertained (each a Represented Beneficiary) and the interests of each Representative Beneficiary to naturally motivate and induce the Representative Beneficiary to adequately protect the interests of each Represented Beneficiary with regard to the subject matter of this Petition; that each Representative Beneficiary has no conflict of interest with each Represented Beneficiary with regard to the subject matter of this Petition; that general family benefits will accrue to the living members of the family of each Represented Beneficiary; that each Representative Beneficiary _ _[*has waived notice and consented to the granting/will receive notice*]_ _ **of this Petition on behalf of himself or herself, as well as all Represented Beneficiaries, and that the interests of every one of the Represented Beneficiaries are adequately protected. To that end, Petitioner makes the following disclosures:**

(a) The present beneficiaries as to Trust income and principal are _ _[*names*]_ _ **(each a Present Beneficiary), whose interests continue for their respective lives.**

(b) _ _[*Names*]_ _ **have each previously received his or her interest in full from the Trust and no longer have any interest in the Trust.**

(c) Each such Present Beneficiary has a testamentary _ _[*limited/special*]_ _ **power of appointment over his or her respective share of Trust income and principal, which may be exercised only in favor of a class of persons who constitute his or her respective issue. (The term "issue" is defined in the attached Trust Instrument.) No Present Beneficiary has a right to withdraw property from the trust** _ _[*except in regard to the following:*]_ _**. Probate Code §15803 does not apply and Probate Code §15804(a)(1) applies. The persons in being who would constitute this class of each respective Present Beneficiary are as follows:**

[*List name, address, relationship to Present Beneficiary, and age of each beneficiary*]

(d) Upon the respective deaths of each Present Beneficiary, any unappointed balance of that Present Beneficiary's trust estate remains in trust for the benefit of that Present Beneficiary's children, by right of representation; and if the deceased Present Beneficiary then has no children, the trust estate is added to the remaining trusts of the other Present Beneficiaries as then existing, by right of representation. Probate Code §15804(a)(2) applies. As to all other future interests (contingent or remainder beneficiary, whether living, unborn, a minor, potentially or actually incapacitated, unascertained, whose identity or address is unknown, or a member of a designated class of persons who are not ascertained), Probate Code §15804(a)(3) applies, such that only the children of each respective Present Beneficiary are to be given notice, inasmuch as all other future interests (Represented Beneficiaries) are virtually represented by the persons to be noticed (Representative Beneficiaries). The children of each Present Beneficiary are as follows:

[*List name, address, and age of each child of each Present Beneficiary*]

[*Continue*]

[5.] Itemization of services of Petitioner:

Petitioner has performed all required duties, including _ _[*e.g., the care and custody of the assets composing the corpus of the trust; collection and disbursements of income; periodic review of the trust assets; making investments and reinvestments in the best interest of the trust estate; preparation and filing of fiduciary income tax returns; and the preparation of this accounting; see also checklist at Cal Rules Ct 7.776*]**_ _; and other services pertaining to the management and administration of the Trust estate.**

[6.] Itemization of services of attorneys:

Attorneys, _ _[*names*]**_ _, employed by Petitioner, performed the following services: being available to Petitioner during the period of the account for all required legal services connected with the Trust and its administration by Petitioner; preparation of this petition for settlement of the account; filing account and petition and setting for hearing, and notifying beneficiaries of hearing on account. Attorneys will in addition present the account and petition to the Court, prepare the order of settlement, and present the order to the Court for signature.**

[*If attorney fees include paralegal time for extraordinary services, consider declaration according to Cal Rules of Ct 7.703(e)*]

[7.] Requested compensation:

Petitioner alleges that Petitioner and attorneys for Petitioner are entitled to reasonable compensation from the Trust for their respective services and that the following sums are reasonable compensation:

a. To Petitioner, the sum of $_ _[*amount*]**_ _.**

b. To attorneys for Petitioner, the sum of $_ _[*amount*]**_ _.**

The compensation to Petitioner and attorneys should be charged _ _[*e.g., one-half to principal and one-half to income*]**_ _.**

[8.] Trust investments:

All investments of the Trust principal shown in this account were authorized and proper investments of the principal of this Trust under its provisions and under the laws of this state, and were made or retained as set forth in this account for the best interests of the Trust and for all interested persons. All cash has been invested and maintained in interest-bearing accounts or in investments authorized by law or the governing instrument, except for that reasonably necessary for the orderly administration of the Trust.

[*Add narrative report describing the following: sales, purchases, changes in the form of assets, and all significant or unusual transactions in the account to extent necessary to constitute adequate disclosure for statute of limitations purposes*]

[9.] Agents of the Trustee:

[*Add statement disclosing any family or affiliate relationship between the trustee and any agent hired by the trustee during the accounting period*]

[10.] Notice:

The sole trustee is Petitioner, who therefore is not required to be given notice. The Trust beneficiaries entitled to notice, all of whom have attained age 18, are set forth in paragraph 4, above, and will be given notice. This Petition does not relate to a charitable trust subject to the jurisdiction of the Attorney General. Therefore, no notice to the Attorney General is required. Petitioner has not received any request for special notice and none are on file to Petitioner's knowledge.

PETITIONER THEREFORE REQUESTS that:

1. Finding that all facts stated in the Petition are true and that all notices required by law have been duly given.

[*If representative interests are used (see §7.65C), add the following paragraph 2*]

2. Finding that the Court has received full disclosure regarding the relationships between _ _[*names*]_ _ (the Representative Beneficiaries in this Petition) and each beneficiary of the Trust who is a minor, potentially or actually incapacitated, unascertained, whose identity or address is unknown, or a member of a designated class of persons who are not ascertained (*i.e.*, the Represented Beneficiaries); they have an identity of interests with regard to all matters related to the Petition without any conflict; each of the Representative Beneficiaries has adequately virtually represented each of the Represented Beneficiaries as to all matters regarding the Petition; and general family benefits will accrue to the living members of the family of each of the Represented Beneficiaries on the granting of the Order.

[*If a guardian ad litem is used, add the following paragraph 3*]

3. Finding that the Court has received full disclosure regarding the relationship between _ _[*name*]_ _, Guardian ad Litem, and _ _[*name*]_ _, minor, and with regard to all matters related to the Petition there is no conflict of interest; such Guardian ad Litem has adequately represented the minor as to all matters regarding the Petition; and general family benefits will accrue to the living members of the family of the minor upon the granting of the Order.

[*Continue*]

[4.] This account and report be settled, allowed, and approved, and all acts and transactions of Petitioner set forth in it, or relating to the matters set forth in it, be ratified, confirmed, and approved.

[5.] Petitioner and the attorneys for Petitioner be allowed the requested compensation for their services.

[6.] Such other and further orders be made as this Court may deem proper under the circumstances.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Petitioner

[*Verification; see §7.116*]

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§7.115 c. Verification of Petition

An account filed under the Probate Code must be verified. Prob C §1021(a)(1). If two or more trustees have a duty to account, the account may be verified by either of them. All trustees, however, will be held responsible for the contents of the account; therefore, all cotrustees should verify the accounting. See §§3.2-3.3. If any cotrustee is unavailable and verification by all is impossible, the attorney for the trustees should make certain that any nonverifying trustee receives a copy as soon as possible and ratifies the account in writing at a later date.

NOTE: When two or more joint fiduciaries have a duty to make the report or account, it may be verified by any of them. Prob C §1021(b)(2).

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.116 d. Form: Verification of Petition

§7.116 d. Form: Verification of Petition

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DECLARATION

I, the undersigned, _ _[*name*]_ _, _ _[*an officer/a trustee/a cotrustee*]_ _ of the _ _ _ _ _ _ Trust, declare that:

I have read the foregoing petition to approve the Trustee's rendering of accounts and know its contents. It is true of my own knowledge except for the matters that are stated in it on information and belief, and regarding those matters I believe it to be true. The accounting attached as Exhibit A contains a full and true statement of all charges against the Trustee and of all credits to which the Trustee is entitled.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _ _ _ _ _ _ __[*Signature of trustee*]__
_ _[*Typed name*]_ _
Petitioner

Comment: The above declaration is valid for declarations executed both within and outside of California, regardless of the law of the place executed. CCP §2015.5. It may be used instead of an affidavit. If an affidavit is used for verification purposes, the notary's seal must show the expiration date of the notary's commission and identify the county where the notary's bond and oath of office are filed. Also, the seal must be reproducible by photocopy and contain a sequential notification number assigned to the notary. Govt C §8207. Make sure that the trustee fills in the date signed, or it will not be a verification under CCP §2015.5.

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§7.117 2. Setting Hearing on Account

The court clerk sets the date for the court hearing on the account when the petition is filed. Prob C §1041. County procedures vary. In some counties the attorney may be able to reserve a date by telephone and then send the papers to the court. When the petition is to be heard in a county that limits the number of matters that can be placed on the calendar in a single day, counsel should try to reserve the date in advance. The date of the hearing can be particularly significant if the court is being asked to approve fees: the tax deduction is available only if fees are approved before the close of the tax year. In most counties the attorney can choose the date for hearing uncontested matters.

If the matter will be contested and the opposition is cooperative, a call to the calendar clerk may be sufficient. If the opposition is uncooperative, the moving party will have to notice the hearing on the calendar. The judge will continue the matter from the date given by the calendar clerk. Contested matters may call for an at-issue memorandum or a settlement conference. After the hearing date is set, notices are mailed to those entitled to them. Prob C §17203. See §7.118.

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§7.118 a. Notice Requirements

The notice requirements for court accountings are the same as for judicial proceedings concerning trusts generally and are governed by Prob C §§1200-1265. Prob C §17100. See also §15.40C and chart in §15.40D. The notice requirements for court-supervised trusts are identical to the notice requirements for nonsupervised trusts. See Prob C §17203. Under Prob C §17105, the petitioner or other person required to give notice may give notice to any person interested in the trust without the need for a court order.

At least 30 days before the date of the hearing, the petitioner or petitioner's attorney must provide notice of the time and place of the hearing. Prob C §17203(a). There is no general requirement that a copy of the petition must also be mailed. Notice is given to all nonpetitioning trustees, all nonpetitioning beneficiaries who are entitled to notice (see Prob C §§15802-15804), and to the Attorney General in the case of a charitable trust. Prob C §17203(a). See also Prob C §17204 on requests for special notice by beneficiaries and creditors of the trust or, if the trust has become irrevocable on the death of the trustor, creditors of the trustee. The court may, for good cause, shorten the time for giving these notices. Prob C §1203. Any person entitled to notice of the proceeding also may waive the notice. Prob C §1204. See form of waiver in §7.120A.

PRACTICE TIP: Obtaining waivers of notice by all persons entitled to notice can allow the hearing to be set at the earliest available court date without waiting for the expiration of the notice period. To preclude a later objection by the beneficiary, and for the information of the court, the attorney should include an acknowledgment of receipt of a copy of the petition and consent to the petition. Check with the court clerk as to any particular local procedure for setting a hearing when no notice is required, *e.g.*, a requirement to still submit a Notice of Hearing form for the clerk's internal calendaring purposes.

The petitioner also must serve notice and a copy of the petition, at least 30 days before the date of the hearing in the manner provided for in CCP §§413.10-417.40 (service of summons), on any person other than a trustee or beneficiary whose right, title, or interest would be affected by the petition who does not receive notice under Prob C §17203(a). The court may not shorten the time for giving notice under Prob C §17203(b). See Prob C §17203(c) if a person entitled to notice is deceased.

Instead of mailing (see Prob C §1215(a)), the petitioner may give notice by personal delivery. Prob C §1216. If an address is unknown, the petitioner must give notice as directed by the court in the manner provided by CCP §413.30. Prob C §1212. The general practice is that the attorney for the petitioner mails the notices. Proof of giving notice is governed by Prob C §§1260-1265.

The petitioner should consult Prob C §15804 (notice in cases concerning a beneficiary's future interest) to determine which remainder beneficiaries should receive notice. See §§7.54, 7.65C. Some trust property may be subject to a general power of appointment and other property subject to a special (limited) power of appointment. Prob C §611(e). The notice requirements of Prob C §15803 apply to the holder of a presently exercisable (not testamentary) general (not limited) power of appointment and a power to withdraw trust property (*e.g., a* "5 or 5" power). The notice requirements of Prob C §15804(a)(1) apply to a testamentary general power of appointment or a testamentary or inter vivos limited power of appointment, and the petitioner must consider all the then-living members of the class of persons eligible to be appointed, as well as all the then-living persons who would take if the power were not exercised.

PRACTICE TIP: In considering future beneficial interests, a trust instrument creating subtrusts, combining subtrusts, providing for specific gifts, or specifying changes of beneficial interest on future events may be unclear as to which presently existing trust the future interest applies. For example, a typical ABC trust may provide for specific gifts on the death of the surviving spouse (*e.g.,* $5000 to the gardener), without specifying that such gifts are to come from the survivor's trust, thus requiring notice to such beneficiaries of any accounting or proceeding concerning the marital trust or credit shelter trust (perhaps causing great embarrassment to the surviving spouse, who perhaps also intended to be able to change the gifts). Before filing any account or other proceeding, therefore, the trustee may wish to petition the court for construction of the trust instrument under Prob C §17200(b)(1) to clarify the

settlors' intentions regarding such specific gifts or other beneficial interest, so that notice requirements as to each subtrust are clear. However, inasmuch as the order construing the trust will affect the named beneficiary's interest to some degree (*e.g.,* whether he or she is determined to be the beneficiary of a revocable subtrust or an irrevocable subtrust, whether the particular subtrust named eventually has the funds to pay out the beneficial interest), failure to give notice to the beneficiary of the petition for construction could result in the order not being res judicata with respect to the beneficiary's interest as it exists under the trust instrument without the court's construction, *i.e.,* the beneficiary may later claim an interest in any or all of the subtrusts.

The court has discretion to require additional notice if it believes that the notice given is insufficient. See Prob C §17206.

If a party entitled to notice files a notice of appearance or a written request for a copy of the petition, the petitioner must send a copy of the petition by mail to that party. Prob C §17205. When requesting a copy of the petition, the requesting party should give an address for receiving notices or petitions. The petition must be sent within 5 days after service of notice of appearance or receipt of the request. It may be easier for the trustee simply to mail a copy of the petition with the notice to avoid further correspondence.

The petitioner can either make proof of giving notice at the hearing, or, as is more common, file a declaration of mailing notice, using the Judicial Council form. Prob C §1260(a). Consult local rules to determine whether proof of service must be filed before the hearing.

See the Judicial Council form of notice reproduced in §7.120.

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§7.119 b. Notice to Minors, Incompetents, Missing Persons, and Unascertained Beneficiaries

Notice may be served on a duly appointed conservator or guardian. Prob C §1210. If none has been appointed for a beneficiary, it is good practice to petition the court for additional notice requirements to eliminate any later claims that notice was not complete. See Prob C §17206. For discussion of guardians ad litem, see §§15.16-15.21. See also discussion of virtual representation in §7.65C.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.120 c. Form: Notice of Hearing--Decedent's Estate or Trust (Probate--Decedents' Estates) (Judicial Council Form DE-120)

§7.120 c. Form: Notice of Hearing—Decedent's Estate or Trust (Probate—Decedents' Estates) (Judicial Council Form DE-120)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, State Bar number, and address):*	*FOR COURT USE ONLY*
TELEPHONE NO.: FAX NO. *(Optional):* E-MAIL ADDRESS *(Optional):* ATTORNEY FOR *(Name):*	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
☐ ESTATE OF *(Name):* ☐ IN THE MATTER OF *(Name):* ☐ DECEDENT ☐ TRUST ☐ OTHER	
NOTICE OF HEARING—DECEDENT'S ESTATE OR TRUST	CASE NUMBER:

This notice is required by law.
This notice does not require you to appear in court, but you may attend the hearing if you wish.

1. NOTICE is given that *(name):*
   (representative capacity, if any):
   has filed *(specify):**

2. You may refer to the filed documents for more information. *(Some documents filed with the court are confidential.)*

3. A HEARING on the matter will be held as follows:

a. Date:	Time:	Dept.:	Room:

b. Address of court ☐ shown above ☐ is *(specify):*

Assistive listening systems, computer-assisted real-time captioning, or sign language interpreter services are available upon request if at least 5 days notice is provided. Contact the clerk's office for *Request for Accommodations by Persons With Disabilities and Order* (form MC-410). (Civil Code section 54.8.)



* Do **not** use this form to give notice of a petition to administer estate (see Prob. Code, § 8100 and form DE-121) or notice of a hearing in a guardianship or conservatorship (see Prob. Code, §§ 1511 and 1822 and form GC-020).

Form Adopted for Mandatory Use
Judicial Council of California
DE-120 [Rev. July 1, 2005]

NOTICE OF HEARING—DECEDENT'S ESTATE OR TRUST
(Probate—Decedents' Estates)

Probate Code §§ 851, 1211, 1215, 1216, 1230, 17100
www.courtinfo.ca.gov

Print

☐ ESTATE OF *(Name):* ☐ IN THE MATTER OF *(Name):* ☐ DECEDENT ☐ TRUST ☐ OTHER	CASE NUMBER:

CLERK'S CERTIFICATE OF POSTING

1. I certify that I am not a party to this cause.
2. A copy of the foregoing *Notice of Hearing—Decedent's Estate or Trust*
   a. was posted at *(address):*

   b. was posted on *(date):*

Date: Clerk, by _____, Deputy

PROOF OF SERVICE BY MAIL *

1. I am over the age of 18 and not a party to this cause. I am a resident of or employed in the county where the mailing occurred.
2. My residence or business address is *(specify):*

3. I served the foregoing *Notice of Hearing—Decedent's Estate or Trust* on each person named below by enclosing a copy in an envelope addressed as shown below AND
   a. ☐ **depositing** the sealed envelope on the date and at the place shown in item 4 with the United States Postal Service with the postage fully prepaid.
   b. ☐ **placing** the envelope for collection and mailing on the date and at the place shown in item 4 following our ordinary business practices. I am readily familiar with this business's practice for collecting and processing correspondence for mailing. On the same day that correspondence is placed for collection and mailing, it is deposited in the ordinary course of business with the United States Postal Service in a sealed envelope with postage fully prepaid.
4. a. Date mailed: b. Place mailed *(city, state):*

5. ☐ I served with the *Notice of Hearing—Decedent's Estate or Trust* a copy of the petition or other document referred to in the Notice.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:

_____ _____

(TYPE OR PRINT NAME OF PERSON COMPLETING THIS FORM) (SIGNATURE OF PERSON COMPLETING THIS FORM)

NAME AND ADDRESS OF EACH PERSON TO WHOM NOTICE WAS MAILED

	Name of person served	Address *(number, street, city, state, and zip code)*
1.		
2.		
3.		
4.		

☐ Continued on an attachment. *(You may use* Attachment to Notice of Hearing Proof of Service by Mail, *form DE-120(MA)/GC-020(MA), for this purpose.)*

* Do not use this form for proof of personal service. You may use form DE-120(P) to prove personal service of this Notice.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.120A d. Form: Waiver of Notice of Hearing and Consent to Petition

§7.120A d. Form: Waiver of Notice of Hearing and Consent to Petition

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[*Title of court*]

In re Trust created under the Will of _ _[*name of decedent*]_ _**, deceased**	)	**No.** _ _ _ _ _ _
[*Or*]	)	**WAIVER OF NOTICE OF HEARING AND ACKNOWLEDGMENT OF RECEIPT OF PETITION (PROBATE CODE §1204)**
In re _ _[*name*]_ _ **Trust, Established under** _ _[*Declaration of Trust/Trust Agreement*]_ _ **dated** _ _[*date*]_ _	)	

I, _ _[*name*]_ _**, hereby waive notice of the time and place of the hearing of the Petition for** _ _[*title of petition*]_ _ _ _[*on behalf of myself and, e.g., all of my issue*]_ _**.**

I hereby acknowledge receipt of a copy of the Petition, and I hereby consent to it _ _[*on behalf of myself and, e.g., all of my issue*]_ _**.**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: Add optional language "on behalf of myself and, *e.g.*, all of my issue" if acting in a representative capacity. See §7.65C.

See discussion of waiver of notice in §7.118.

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§7.121 3. Hearing on Account

In most counties, the trustee's attorney need not appear in support of an uncontested petition and account. The court may require the appearance of the trustee's attorney if the accounting shows any actions about which the court wishes further information. Because the procedures governing the hearing on a trustee's account differ from county to county, the attorney should consult local rules and, if necessary, the probate commissioner or county clerk.

Before the hearing, the filed verified petition (see §7.114) and the accounting (see §§7.71-7.111) are reviewed by the court to ensure that they conform to procedural and substantive requirements of the Probate Code and local rules.

After the account is filed with the court, any beneficiary may file objections to it either through an attorney or in pro per. See *Estate of Traung* (1962) 207 CA2d 818, 836, 24 CR 872. The form of the objection must comply with local rules.

The court has jurisdiction to review all matters covered in the accounting. Prob C §§17000-17001. Regarding the burden of proof, the trustee has the general duty to establish the correctness of an account, and also has the benefit of a presumption of good faith and regularity. Once the trustee substantiates the account and report by substantial evidence, the burden of proof shifts to a challenger to show that the item in question is wrong. See *Neel v Barnard* (1944) 24 C2d 406, 420, 150 P2d 177. The principle behind the burden of proof is to ascertain the status quo, *i.e.*, the baseline of what would happen if the court did nothing. See *Conservatorship of Hume* (2006) 140 CA4th 1385, 1388, 44 CR3d 906, in which the court held that the statutory requirement for a conservator to file an inventory and appraisal under oath was met by the filing such that any objector to the appraisal had the burden of proof. The *Hume* decision was followed in the context of an objection to a guardianship account in *Guardianship of K.S.* (2009) 177 CA4th 1525, 100 CR3d 78 (noting that conservatorship and guardianship statutory accounting requirements are similar).

In the context of a trust account, the question would be one of identifying the status quo, *i.e.*, is the trustee, under the trust instrument in light of statutory requirements, required to account and has that duty been met? If so, then under the broad principles of *Neel* and *Hume*, the burden would shift to the objector. However, the court in *Hume* made a distinction where the action was taken voluntarily because in that case the status quo is in taking no action. In the *Hume* conservatorship context, the voluntary action was the filing of the objection. In the context of a trust account where, under the trust instrument, an account by the trustee is voluntary and not required, it may be that the burden of proof would remain with the trustee.

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§7.122 4. Order Settling Account

The attorney should present an order for the judge or commissioner to sign. Usually the order is submitted before the hearing date. Some counties prefer that it be submitted with the petition so that both are reviewed together by the probate attorney; other counties will accept the order only after the petition has been calendared. If there are changes, the judge will either ask the attorney to submit a revised order, which comports with the rulings made, or line through or make other modifications to those items that conflict with the ruling made at the end of the hearing.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.123 a. Form: Order Settling Account

§7.123 a. Form: Order Settling Account

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In re Trust created under the Will of _ _[*name of decedent*]_ _, Deceased	**No. _ _ _ _ _ _**
[*Or*]	**ORDER SETTLING ACCOUNT AND REPORT OF TRUSTEE AND ALLOWING COMPENSATION TO TRUSTEE AND ATTORNEYS**
In re _ _[*name*]_ _ Trust, Established _ _[*date*]_ _	**Hearing: _ _[*date*]_ _**
	Time: _ _[*time*]_ _
	Dep't: _ _[*number*]_ _

_ _[*Name*]_ _, the Trustee (hereafter referred to as "Petitioner") of the Trust under the _ _[*Will of _ _[name]_ _ deceased, and the decree of distribution of decedent's estate/trust agreement created by _ _ _ _ _ _]_ _, has filed the _ _[e.g., first]_ _ account and report of the administration of the Trust for the period from _ _[*date*]_ _, to _ _[*date*]_ _, inclusive, and has petitioned for settlement of the account and for allowance of compensation to Trustee and attorneys. The petition having come on regularly this day for hearing, the Court finds:

All facts stated in the Petition are true and notice of the hearing of the petition has been given as required by law.

[*If representative interests are used (see §7.65C), add the following paragraph 2*]

The Court has received full disclosure regarding the relationships between _ _[*names*]_ _ (the Representative Beneficiaries herein) and each beneficiary of the Trust who is a minor, potentially or actually incapacitated, unascertained, whose identity or address is unknown, or a member of a designated class of persons who are not ascertained (*i.e.*, the Represented Beneficiaries); the Representative Beneficiaries and the Represented Beneficiaries have an identity of interests with regard to all matters related to the Petition without any conflict; each of the Representative Beneficiaries has adequately virtually represented each of the Represented Beneficiaries as to all matters regarding the Petition; and general family benefits will accrue to the living members of the family of each of the Represented Beneficiaries on the granting of the Order.

[*If a guardian ad litem is used, add the following paragraph 3*]

The Court has received full disclosure regarding the relationships between _ _[*name*]_ _, Guardian ad Litem, and _ _[*name*]_ _, minor, and with regard to all matters related to the Petition there is no conflict of interest; such Guardian ad Litem has adequately represented the minor as to all matters regarding the Petition; and general family benefits will accrue to the living members of the family of the minor on the granting of the Order.

[*Continue*]

The account and report should be approved as filed and the acts and transactions of Petitioner approved.

Compensation for the services of Trustee and attorneys rendered to the Trust during the period of the account and in connection with the accounting to this Court should be allowed and charged as ordered below.

IT IS ORDERED that:

1. The _ _[*e.g., first*]_ _ account and report of Trustee is approved as filed.

2. All acts and transactions of Petitioner as set forth in the account and report, or relating to the matters set forth in it, are ratified, confirmed, and approved.

3. Compensation for services rendered to the Trust is allowed as follows:

a. To _ _ _ _ _ _, as Trustee, the sum of $_ _[*dollar amount*]_ _.

b. To _ _ _ _ _ _, attorneys for Trustee, the sum of $_ _[*dollar amount*]_ _.

4. The compensation so allowed shall be paid by Trustee from the trust estate and charged _ _[*e.g., one-half to income and one-half to principal*]_ _.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the _ _[*title of court*]_ _

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§7.124 b. Effect of Order Settling Account

The order approving and settling the account is conclusive on all persons and interests, assuming proper notice has been given, and cuts off all suits against a trustee for acts fully disclosed in the account. See Prob C §1260(c); *Estate of Bissinger* (1964) 60 C2d 756, 765, 36 CR 450; *Lazzarone v Bank of America* (1986) 181 CA3d 581, 591, 226 CR 855.

An appeal from an order approving a court account must be filed within 60 days after the court clerk mails notice of entry of judgment showing the date it was mailed, 60 days after the party filing the notice of appeal serves or is served by a party with a notice of entry of judgment (accompanied by proof of service), or within 180 days after the date of entry of the order, whichever is the earliest. Prob C §1300(b); Cal Rules of Ct 8.104(a).

NOTE: Mailing a "file-stamped" copy of the order will suffice as a notice of entry of judgment. "There can be no better notice of what an order says than is provided by a file-stamped copy of the order itself." *Parris v Cave* (1985) 174 CA3d 292, 294, 219 CR 871.

PRACTICE TIP: To shorten the time for filing an appeal from 180 days to 60 days, mail all parties a notice of entry of judgment or a file-stamped copy of the order. Check whether the local court has its own form for notice of entry of judgment.

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§7.125 V. POSTACCOUNTING TRANSACTIONS

Inasmuch as the general duty of the trustee "to keep the beneficiaries of the trust reasonably informed of the trust and its administration" under Prob C §16060 is separate from and potentially broader than the duty to account under Prob C §§16061 and 16062, the trustee may be required to provide additional information under Prob C §16060 even after an account has been provided. See §7.1.

If the account is not the final account and the trustee has given a bond, the accounting may indicate that the bond should be increased, decreased, or released. See Prob C §15602.

After final transactions have occurred (income received, closing expenses paid) and all distributions have been made, the trustee should provide an informal accounting, often referred to as a "Closing Statement," to all beneficiaries, starting with the balances on hand at the end of the final accounting and listing the receipts, disbursements, and distributions showing a final balance of zero, along with a receipt for final closing distribution (see §16.56 for a form that may be adapted whether a court accounting or non-court accounting has been used. This statement should be sent with the final checks closing the account. The closing statement should satisfy the requirements of Prob C §16063 in order to commence the 3-year statute of limitations under Prob C §16460(a)(1). See §7.64A. Additionally, if the trust contains a provision relieving the trustee of liability if a beneficiary fails to object to an item in an account or report within a specified time period and the other requirements of Prob C §16461 are met, the trustee should include the notice to beneficiaries provided in Prob C §16461(c). See §§7.53, 7.61, 7.65.

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Source: Estate Planning/California Trust Administration/7 Recordkeeping and Accounting/§7.126 VI. USING THE ACCOUNTING SPREADSHEETS

§7.126 VI. USING THE ACCOUNTING SPREADSHEETS

To save this Excel spreadsheet, right click here and choose Save Target As.

NOTE: After installation of the files from the disk that accompanies this book, you will find a Microsoft Excel file that contains a preformatted shell for all the various accounting schedules that may be required in a court accounting. This file is named 07-126 and is located in the folder "Ch07." You will need Microsoft Excel 97 or higher and a basic knowledge of the program to use the worksheets in this file.

The shell consists of layers of spreadsheets for entering accounting information. The first spreadsheet is used for the heading. Enter the name of the trust in cell A1 (replacing the language in parenthesis "Insert Matter Title; *e.g.,* THE SMITH FAMILY TRUST"). Also replace the parenthetical language in cells A3 and A4 as appropriate. This heading will then be transferred to all the underlying worksheets of the accounting.

The next worksheet is the summary page, which generates the Summary of Account. No data entry is required for this worksheet. The totals for schedules A through J of the accounting are linked to this worksheet, which adds itself, thus simplifying the process of balancing the accounting by eliminating errors made in addition.

The next worksheet is "Supsch," which generates an index that can be used to identify which additional supporting schedules under Prob C §1062 apply and are attached in the particular accounting being generated. The next worksheet is "Sch A," which generates schedule A, the property on hand at the beginning of the accounting period. Rows can be inserted or deleted as necessary depending on the number of assets in the particular accounting. Note that the value column totals itself, again eliminating errors in addition. Be aware, however, that adding a row outside the original range requires updating the formula that produces the total.

Each additional worksheet represents a schedule in the accounting. As previously mentioned, the totals for schedules A through J are linked to the summary page, making the act of balancing the accounting less cumbersome.

CAVEAT: Before using the spreadsheet on the accompanying disk, always be sure to make a backup copy that can be used in the event of errors in the working version.

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8

Principal and Income

Michael Antin
Michael L. Taylor

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I. TRUSTEE POWERS AND DUTIES UNDER UNIFORM PRINCIPAL AND INCOME ACT

§8.1 A. Purposes of Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375)

California's Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) is based on the Uniform Principal and Income Act of 1997 approved by the National Conference of Commissioners on Uniform State Laws (NCCUSL), as amended in 2008, which has two main purposes (Uniform Act Prefatory Note, reprinted in 29 Cal L Rev'n Comm'n Reports 251 (1999)):

1. To revise the prior 1931 and 1962 uniform acts to reflect the widespread use of the revocable living trust as a will substitute; to cover situations not provided for, including establishing new rules applicable to financial instruments invented since 1962; and make other needed changes; and
2. To provide a means for implementing an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return instead of for a certain level of "income" as traditionally perceived in terms of interest, dividends, and rents.

The UPAIA brings within its ambit estates administered in probate, as well as trusts becoming irrevocable on the settlor's death and terminating trusts. The provisions of the UPAIA are default provisions; specific provisions in the terms of a trust that differ from the provisions in the UPAIA are controlling. See §8.2. In the absence of contrary directions from the settlor, the trustee classifies trust property as income or principal under the terms of the UPAIA.

The UPAIA should encourage uniformity of treatment of principal and income for all beneficial interests of trusts. The Internal Revenue Service has issued regulations designed to accommodate state laws consistent with the Uniform Principal and Income Act of 1997 and the federal Uniform Prudent Investor Act. See §§8.3A-8.3E.

PRACTICE TIP: The California Law Revision Commission comments to UPAIA, as well as the comments to the Uniform Principal and Income Act of 1997, are often helpful in explaining or clarifying the statutory language.

Many trusts have more than one class of beneficiary. Trusts commonly provide that some beneficiaries will receive trust income during their lifetimes. When the life beneficiaries die, remainder beneficiaries receive the remaining principal. Therefore, in trust accounting, trustees often must distinguish trust principal from income to ensure that different classes of beneficiaries are treated fairly (*i.e.,* impartially) and are treated according to the provisions of the trust, both administratively and dispositively.

Because of the difficulties involved in traditional trust accounting, however, many trusts now provide that current beneficiaries will receive a set amount (annuity trust) that may or may not be adjusted for inflation or a set percentage of trust assets (unitrust) per year, or provide only for discretionary payments, unless the beneficiary is required to have an income interest because the trust is intended to qualify for the estate tax marital deduction. In most cases, a unitrust interest can be used by the trust drafter instead of an income interest for the spouse, and an income interest in an existing trust can be converted into a unitrust interest. See §8.3F. In some cases, this option may be precluded by the language of the trust instrument or by the presence of hard-to-value trust assets, and some trust beneficiaries may not agree to a unitrust conversion. If no beneficiary has a mandatory income interest, the trust will usually provide that net income is added to trust principal, in which case it is generally unnecessary to distinguish trust principal from income.

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B. Subordination of UPAIA to Terms of Trust Instrument

§8.2 1. Trustee Must Follow Directions

A settlor or testator may include guidelines in the trust instrument to indicate how the trustee is to allocate receipts and disbursements between principal and income. The instrument may define what constitutes trust income and principal, how each should be allocated to the interests of different classes of beneficiaries, and what costs are allocable to either or both. The trustee must follow such directions even when they contradict provisions of the UPAIA. Prob C §§16000, 16335(a)(1).

PRACTICE TIP: When drafting the trust instrument, the attorney can resolve questions in advance by setting forth the rules for governance of principal and income issues. Even irrevocable trusts may sometimes be amended to correct problems that arise after the facts establishing the irrevocability of the trust. See Prob C §§15403-15404, discussed in chap 16.

Trust instruments often contain clauses giving trustees discretion to determine the allocation of an item as income or principal or as an expense against either of them. See §8.3. If the trust is silent about allocation of principal and income and does not give the trustee discretion, the allocation should be made in accordance with the provisions of the UPAIA. Prob C §16335(a)(3). If both the governing instrument and the Act are silent about how to credit a receipt or charge a disbursement, the trustee must add the receipt or charge the disbursement to principal. Prob C §16335(a)(4).

However, the trustee generally may convert an income interest into a unitrust interest with consent of the beneficiaries unless expressly prohibited by the trust instrument. Prob C §16336.4(a). See §8.3F. Under some circumstances, the trustee can make adjustments between principal and income even if the governing instrument does not give the trustee discretion. Prob C §16336. See §§8.4-8.8.

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§8.3 2. Trustee May Exercise Discretion

If the trust or will gives the trustee a discretionary power of administration, the trustee may exercise that power, even if doing so produces a result different from the one the statute would have produced. Further, the exercise of discretion that produces such a nonconforming result does not raise any inference that the fiduciary has acted wrongfully. Prob C §16335(a)(2).

Unless the governing instrument expresses an intention that the trustee shall or may favor one or more of the beneficiaries, the trustee is bound to exercise a discretionary administrative power impartially. Such an exercise of discretion is presumed to be fair and reasonable to all beneficiaries. Prob C §16335(b).

The Comment to Prob C §16335 (29 Cal L Rev'n Comm'n Reports 269 (1999)) notes that

> whenever there are two or more beneficiaries, a trustee is under a duty to deal impartially with them. Restatement of Trusts 3d: Prudent Investor Rule §183 (1992) [now Restatement (Third) of Trusts §79 (2007)]. This rule applies whether the beneficiaries' interests in the trust are concurrent or successive. If the terms of the trust give the trustee discretion to favor one beneficiary over another, a court will not control the exercise of such discretion except to prevent the trustee from abusing it.… The precise meaning of the trustee's duty of impartiality and the balancing of competing interests and objectives inevitably are matters of judgment and interpretation. Thus, the duty and balancing are affected by the purposes, terms, distributions, requirements, and other circumstances of the trust not only at the outset but as they may change from time to time.

PRACTICE TIP: The prudent fiduciary can apply to the court for instructions if given discretion to favor one beneficiary or under other potentially problematic circumstances.

The trustee's exercise of discretion is also subject to Prob C §16081, which requires a trustee to act in good faith and for the purposes of the trust when exercising any discretionary power. Even under a grant of absolute discretion, Prob C §16081 requires the trustee to act in accordance with fiduciary principles and not to act in bad faith. See *Penny v Wilson* (2004) 123 CA4th 596, 20 CR3d 212. The trustee's discretion is also subject to Prob C §16040, which sets the standard of care to be exercised in the administration of a trust, and Prob C §16047, which sets out the prudent investor rule for management and investment of trust assets. See discussion in chap 2. Probate Code §16042 defines the standard of care with respect to trust property held by the public guardian or administrator appointed as trustee of a trust under Prob C §15660.5.

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.3A C. Consequences of Definition of Trust Income Under Treas Reg §1.643(b)-1

§8.3A C. Consequences of Definition of Trust Income Under Treas Reg §1.643(b)-1

The IRS regulations provide for three alternative definitions of trust income under IRC §643(b) (Treas Reg §1.643(b)-1):

- Income as determined under the traditional definition of income.
- Income as determined under applicable local law, if local law provides for a "reasonable apportionment" of the total return of the trust between principal and income, such as:
- The power to adjust if necessary to fulfill the trustee's duty of impartiality (see §8.3B); or
- A unitrust conversion power if the unitrust amount is between 3 and 5 percent of the trust assets' fair market value (see §8.3E).
- Allocation of gains from sale or exchange of trust assets to income under specific circumstances (see §§8.3C-8.3D; see also §11.49).

Items such as dividends, interest, and rents are generally allocated to income under the traditional definition of income; proceeds from the sale or exchange of trust assets are generally allocated to principal. Thus, a trust that fundamentally departs from traditional principles of income and principal (such as a trust that directs that all trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal) will generally not be recognized.

The IRS regulations are designed to accommodate issues raised by the adoption of the federal Uniform Prudent Investor Act and the Uniform Principal and Income Act of 1997 and unitrust conversion statutes in states' laws. TD 9102, 2004-1 Cum Bull 366. California's Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) changes traditional concepts of income and principal in response to investment strategies that seek total positive return on trust assets. For example, under the prudent investor standard as adopted in California, the trustee must consider the total return on trust assets as one element when making investment decisions. Prob C §16047(c)(5). Under this investment strategy, trust assets should be invested for total positive return, *i.e.,* ordinary income plus appreciation, in order to maximize the value of the trust (*e.g.,* the trustee favors equities over the more traditional bonds).

These state statutes are designed to ensure that, when a trust invests in assets that may generate little traditional income (including dividends, interest, and rents), the income and remainder beneficiaries are allocated reasonable amounts of the total return of the trust (including both traditional income and capital appreciation of trust assets) so that both classes of beneficiaries are treated impartially.

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§8.3B 1. Equitable Adjustments Between Principal and Income Respected

Adjustments between principal and income will be respected if they are, under applicable state law, a "reasonable apportionment between the income and remainder beneficiaries of the total return of the trust." Equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between income and remainder beneficiaries are generally considered a reasonable apportionment. Treas Reg §1.643(b)-1.

Under the regulations, equitable adjustments are permitted when (Treas Reg §1.643(b)-1):

- The trustee operates under the state's prudent investor standards;
- The trust describes the amount distributed to the beneficiary by referring to trust income; and
- After applying the state income and principal statute, the trustee cannot act impartially. See §8.5.

The consequences are the following if the requirements of Treas Reg §1.643(b)-1 are satisfied:

- If qualification for an estate or gift tax deduction depends on a spouse having an income interest for life, a problem arises if an adjustment power might result in distributions that are lower than those resulting under traditional trust rules. Under the regulations, a spouse's interest in a marital deduction trust satisfies the income standard (as set forth for the gift and estate tax marital deduction) if the spouse is entitled to income as defined under a state statute that provides for a reasonable apportionment between income and remainder beneficiaries. Treas Reg §§20.2056(b)-5(f)(1), 25.2523(e)-1(f)(1). The power to make an equitable adjustment will not be considered a power to appoint trust property to a person other than the surviving spouse. Treas Reg §20.2056(b)-7.

NOTE: Under California law, the trustee may not make an adjustment if it would diminish the income interest in a trust that requires all income to be paid at least annually to a spouse and for which, if the trustee did not have the adjustment power, an estate tax or gift tax marital deduction would be allowed. Prob C §16336(b)(1). See §8.6. Instead of using the adjustment power, the trustee should consider a unitrust conversion. See §8.3F.

- The administration of a pre-September 25, 1985, trust that permits equitable adjustment between income and principal to ensure impartiality will not be treated as a modification that shifts a beneficial interest to a lower generation beneficiary or increases the amount of a generation-skipping transfer (GST). In short, the adjustment will not result in loss of the exempt status of a grandfathered generation-skipping trust. Treas Reg §26.2601-1(b)(4)(i)(D)(2). See §8.8A.
- A switch between methods of determining trust income authorized by state law will not constitute a taxable exchange and will not give rise to gift tax consequences to any trust beneficiary. However, a switch to a method not specifically authorized by state statute but valid under state law (including a switch via judicial decisions or a binding nonjudicial settlement) may constitute a recognition event to the trust or its beneficiaries under IRC §1001 and may result in taxable gifts from the trust's grantor and beneficiaries. Treas Reg §1.643(b)-1.
- Capital gains recognized by a pooled income fund (IRC §642(c)(5)) qualify for the charitable deduction under current law because they are permanently set aside for charity. The charitable deduction for gains will be lost, however, if, under the terms of the governing instrument and state law, income may include an equitable adjustment with respect to unrealized appreciation in the value of trust assets. Treas Reg §1.642(c)-2(c).

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.3C 2. Allocation of Capital Gains to Income Allowed

§8.3C 2. Allocation of Capital Gains to Income Allowed

The trustee is allowed to allocate gains from the sale or exchange of capital assets to income if made pursuant to:

- Governing instrument and local law; or
- A reasonable and consistent exercise of discretionary power granted by the governing instrument and local law. Treas Reg §1.643(b)-1; IRC §643(a)(3).

NOTE: Capital gain attributable to appreciation after the date of contribution or purchase by a charitable remainder unitrust may be allocated to income under the terms of the governing instrument and governing law, but not under a discretionary power. Treas Reg §1.664-3(b)(3). If income is defined as a unitrust amount, the amount of gain allocated to income may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to Treas Reg §1.664-3(b). Treas Reg §1.664-3(b)(1).

Under either standard, capital gains will be included in distributable net income if (Treas Reg §1.643(a)-3(b)):

- They are allocated to corpus but utilized by the trustee to determine the amount that is distributed to a beneficiary (*e.g.,* capital gains are used to describe amount or timing of a distribution to beneficiary); or
- They are allocated to corpus but treated by the trustee on the trust's books, records, and tax returns as part of a distribution to a beneficiary (*e.g.,* the trustee pursuant to a discretionary power treats the capital gain as distributed to beneficiary).

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.3D 3. Distribution in Kind Treated as Sale of Property

§8.3D 3. Distribution in Kind Treated as Sale of Property

The regulations take the position that a distribution of property in kind for purposes of satisfying a right to income will be treated as a sale of the property by the trust for fair market value, followed by a distribution in cash. Treas Reg §§1.651(a)-2(d), 1.661(a)-2(f). However, the in-kind use of a residence or other personal use property owned by the trust may be treated as a distribution of income without income tax consequences. See Note in §8.3F.

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§8.3E 4. When Unitrust Amount May Be Treated as Income Under State Law

The regulations permit the trustee to treat as income of the trust a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of trust assets, whether determined annually or averaged on a multiple-year basis, if provided by state law. Treas Reg §1.643(b)-1. The alternative unitrust definition of trust income is incorporated by reference in the QTIP regulations. Treas Reg §§20.2056(b)-7(d)(1), 25.2523(f)-1(f)(1). Thus, the surviving spouse's income interest in a typical marital deduction qualifying trust can be converted into a unitrust interest meeting the regulation definition. Further, a marital deduction qualifying trust may be drafted to give the surviving spouse a unitrust interest. California law permits a unitrust interest to be used as an income interest and authorizes the trustee to convert an income interest into unitrust interests. See §8.3F.

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.3F D. Unitrust Conversion Power

§8.3F D. Unitrust Conversion Power

Under Prob C §16328, a unitrust amount of between 3 and 5 percent will be treated as net income during any accounting period in which the trust is administered as a unitrust pursuant to the powers conferred by Prob C §§16336.4-16336.6, or pursuant to the terms of the governing instrument. This provision is of particular importance to marital deduction qualifying trusts, which are generally required to pay the net income of the trust to the surviving spouse. See §8.3E. However, income of an income-only charitable remainder unitrust may not be defined using a unitrust amount. Treas Reg §1.664-3(a)(1)(i)(b)(3). This rule avoids the absurd result that a trust that pays the greater of a unitrust amount or trust income may be required to pay the greater of two different unitrust amounts—one of which will always be greater. Consistent with the treatment of exempt trusts when the adjustment power is exercised (see §8.3B), unitrust conversion will not result in the loss of a zero generation-skipping transfer (GST) tax inclusion ratio. Treas Reg §26.2601-1(b)(4)(i)(E), Example 11; IRS Letter Ruling 200702013.

Unless expressly prohibited by the governing instrument, the trustee may convert a trust providing for distribution of income into a unitrust. Prob C §16336.4. The term "income" in a converted trust means an annual distribution of a unitrust amount of 4 percent of the net fair market value of trust assets, except as otherwise agreed by the parties or ordered by the court under Prob C §16336.5. Prob C §16336.4(e). However, in determining the unitrust amount, the value of residential property and tangible personal property that one or more current beneficiaries have the right to occupy or to possess or control other than in the capacity of trustee is not included. Prob C §16336.4(e)(4)(A).

The exclusion of residential property and other personal use property from the determination of the unitrust amount is intended to simplify trust accounting, especially when it is expected that the surviving settlor will continue to occupy the family residence and the decedent's interest in the property may be allocated to a marital deduction qualifying trust. Ordinarily, the spouse's use of residential property in kind would satisfy the income requirement with respect to the property for purposes of the marital deduction. If the value of the residence were included in determining the unitrust amount, however, the trust would have to generate cash to make unitrust payments to the spouse based on the value of the decedent's interest in the property, while the trustee would have a fiduciary obligation to the remainder beneficiaries to compel the spouse to pay rent to the trust for the use of the residence. This could have income tax consequences because the spouse is not treated as the owner of the trust for income tax purposes. The exclusion does not apply to other real property such as farm or ranch property.

In addition to the residential property exception, the following assets are excluded from the fair market value calculation:

- Specifically devised property, if including such property in the calculation would create "a material risk of exhausting other trust assets prior to termination of the trust" (Prob C §16336.4(e)(4)(B)).

EXAMPLE: In a converted unitrust with a payout percentage of 4 percent and $1 million in assets, consisting of a parcel of undeveloped land with a fair market value of $500,000 specifically devised to one beneficiary on the termination of the trust and $500,000 in other assets, the trustee may exclude the land from the unitrust calculation with the consequence that the income beneficiary of the trust will receive $20,000 per year plus any net income from the land.

- Any asset while held in a testator's estate or a terminating trust (Prob C §16336.4(e)(4)(C)).

Under Prob C §16336.5(a), the trustee may adopt a payout percentage of not less than 3 percent and not more than 5 percent without court order if all beneficiaries consent. Under Prob C §16336.5(b), the court may order a unitrust conversion with a payout percentage of between 3 and 5 percent if a beneficiary objects, or a beneficiary may petition the court to order the conversion.

The trustee may reconvert the trust from a unitrust or change the payout percentage without court order after 3 years if the trustee determines that reconversion or change in payout percentage would enable the trustee to better satisfy the duty to administer the trust impartially under Prob C §16335(b) and specified notice requirements are met, or the court may order the reconversion or change in payout percentage. Prob C §16336.6.

NOTE: A switch between methods of determining trust income authorized by state statute will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. See Treas Reg §1.643(b)-1.

In a proceeding concerning the trustee's exercise or nonexercise of the unitrust conversion power, as is the case in proceedings concerning the exercise or nonexercise of the adjustment power (see §8.10), the sole remedy is to direct the trustee to convert the trust to a unitrust, to reconvert from a unitrust, to change the payout percentage, or to order any other necessary or helpful administrative procedures. Prob C §16338. As, again, is the case with the adjustment power, the Probate Code does not impose a duty on the trustee to convert or reconvert a trust or to consider a conversion or reconversion. Prob C §16336.7(a).

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§8.4 E. Power to Adjust Between Principal and Income

A fiduciary may make an adjustment between principal and income if certain conditions are met (Prob C §16336(a); see §8.5) and may not make an adjustment under certain other circumstances (Prob C §16336(b); see §8.6).

The Comment to Prob C §16336 states that the purpose of this section is to reconcile the tension between the trustee's duties under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) and the technical trust accounting rules governing allocations between principal and income in the UPAIA. The power to make adjustments is discretionary and, like all discretionary trust powers, subject to the terms of the trust and the law of trusts. A trustee may wish to seek an agreement from the beneficiaries or to petition the court for instructions under Prob C §17200(b)(5) before exercising the power. 29 Cal L Rev'n Comm'n Reports 271 (1999).

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§8.5 1. When Adjustment Allowed

A fiduciary may make an adjustment between principal and income if the following conditions are met (Prob C §16336(a)):

- The trustee invests and manages trust assets in accordance with the prudent investor rule (Prob C §16047);

NOTE: Issues may arise with respect to this condition when the governing instrument contains significant investment restrictions.

- The trust describes the amount that shall or may be distributed to a beneficiary by referring to the trust's income; and
- The trustee determines, after applying the rules in Prob C §16335(a), that he or she is unable to comply with Prob C §16335(b), *i.e.,* that without an adjustment the trustee cannot administer the trust impartially with respect to the beneficiaries.

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§8.6 2. When Adjustment Not Allowed

A trustee may not make an adjustment between principal and income during any period in which the trust is being administered as a unitrust or under the following circumstances, most of which involve a negative impact on an otherwise favorable tax treatment (Prob C §16336(b)):

- When the adjustment would diminish the income interest in a trust that requires all income to be paid at least annually to a spouse and for which, if the trustee did not have the power to adjust, an estate tax or gift tax marital deduction would be allowed;
- When the adjustment would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;
- When the adjustment would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;
- When the adjustment would be made from any amount that is permanently set aside for charitable purposes, unless both income and principal are set aside;

NOTE: It is questionable whether this language precludes the exercise of the adjustment power with a charitable remainder trust that distributes the lesser of income or a unitrust percentage.

- When possessing or exercising the power to make an adjustment would cause an individual to be treated as the owner of all or part of the trust for income tax purposes and the individual would not be treated as the owner if the trustee did not possess the power;
- When possessing or exercising the power to make an adjustment would cause all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove or appoint a trustee and the assets would not be included in the individual's estate if the trustee did not possess the power; or
- When the trustee is a beneficiary of the trust.

Notwithstanding Prob C §15620 (which requires that the exercise of power vested in cotrustees be by unanimous action), when any of the latter three circumstances applies to one cotrustee, a cotrustee to whom the circumstance does not apply may make the adjustment unless forbidden by the trust. Prob C §16336(c). Presumably, a provision in a trust instrument requiring unanimous action by the trustees to bind the trust would preclude any cotrustee from making an adjustment.

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§8.7 3. Release of Power to Make Adjustment

A trustee may release all or part of the power to make an adjustment if the trustee is uncertain whether its possession or exercise will cause the negative consequences described in Prob C §16336(b) or if the trustee determines that its possession or exercise may deprive the trust of a tax benefit or impose a tax burden not described in Prob C §16336(b). Prob C §16336(d). This release may be permanent or for a specific time (*e.g.*, an individual's lifetime). Prob C §16336(e). A trust that limits the trustee's power to make adjustments between principal and income does not affect the application of Prob C §16336, unless it is clear from the trust that it is intended to deny the power of adjustment under §16336(a). Prob C §16336(f).

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§8.8 4. Factors to Consider in Deciding Whether to Exercise Adjustment Power

The Comment to Prob C §16336 points out that, although Prob C §16336 does not mandate consideration of certain factors, as does the Uniform Principal and Income Act of 1997, the Uniform Act factors provide useful guidance when deciding whether to exercise the power to make adjustments. 29 Cal L Rev'n Comm'n Reports 271 (1999). They include the following:

- The nature, purpose, and expected duration of the trust;
- The settlor's intent;
- The identity and circumstances of the beneficiaries;
- The needs for liquidity, regularity of income, and preservation and appreciation of capital;
- The trust assets; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;
- The net amount allocated to income under other sections of the UPAIA and the increase or decrease in the value of the principal assets, which the trustee may estimate if market values are not readily available;
- Whether and to what extent the trust gives the trustee the power to invade principal or accumulate income or prohibits the trustee from doing so and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;
- The actual and anticipated effect of economic conditions on principal and income and the effects of inflation and deflation; and
- The anticipated tax consequences of an adjustment. See §8.8A.

The trustee may give notice to the beneficiaries as set out in Prob C §§16337, 16500-16504 before exercising the power to make an adjustment. See §8.9.

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.8A F. When Adjustment or Unitrust Conversion Does Not Result in Taxable Gift

§8.8A F. When Adjustment or Unitrust Conversion Does Not Result in Taxable Gift

In a private letter ruling, the Internal Revenue Service examined the effect on gift taxes of state laws that allow a trustee to make an adjustment between principal and income. The Service ruled that under New York law the power to adjust between principal and income did not result in gifts to the beneficiaries if the trustees followed the state law procedures and were neither current beneficiaries nor presumptive remaindermen. IRS Letter Ruling 200334025.

In this ruling the trustees were not current beneficiaries, but the named trustees had some contingent interest. The Service found that under New York case law "presumptive remaindermen" are "persons presumptively entitled to the next eventual estate." Because neither trustee's indirect contingent interest was the "next eventual estate," neither trustee was a "presumptive remainderman." Under Treas Reg §25.2511-1(g)(2), however, a beneficially interested trustee who transfers trust property to another beneficiary makes a taxable gift, unless the exercise of the trustee's power is limited by a reasonably fixed or ascertainable standard set forth in the trust instrument.

In *Matter of Heller* (2006) 816 NYS2d 403, 849 NE2d 262, the court rejected the argument that the trustees of a net income trust were barred from electing a unitrust conversion because they were themselves remainder beneficiaries of the trust. The unitrust conversion had the effect of substantially reducing the amount paid to the income beneficiary—in effect converting trust accounting income to principal. The court held that a New York statute (generally similar to the California statute discussed in §8.3F) did not impede a unitrust election by an interested trustee, and that such an election was not inconsistent with common law limitations on the conduct of fiduciaries. The court noted that there was no prohibition on beneficially interested trustees in the unitrust provisions of the statute. The court further noted that, while the common law contains an absolute prohibition against self-dealing, in this case the trustees owed a fiduciary duty to the other remainder beneficiaries as well as to the income beneficiary. Because of these differences from the legal situation in the letter ruling, it is unclear whether a unitrust conversion could result in taxable gifts by beneficially interested trustees.

Beneficiaries of a grandfathered generation-skipping trust will not incur any gift tax consequences if the trustee uses the power to adjust or converts to a unitrust, as long as the state statute allowing such action provides a "reasonable apportionment" between income and remainder beneficiaries. Treas Reg §26.2601-1(b)(4)(i)(D)(2), (E), Examples 11-12.

NOTE: There is no explicit parallel provision regarding the effect of the power to adjust in the estate tax regulations. However, Treas Reg §20.2041-1(b)(1) states that a management power that does not "enlarge or shift any of the beneficial interests [in the trust] except as an incidental consequence of the discharge of… fiduciary duties is not a power of appointment" for federal estate tax purposes.

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§8.9 G. Notice of Proposed Action for Adjustment or Unitrust Conversion

A trustee may give notice of a proposed action such as a unitrust conversion regarding a matter governed by the UPAIA as provided in Prob C §§16500-16504. Prob C §16337. The procedure is similar to the notice of proposed action procedure under the Independent Administration of Estates Act (IAEA) (see Prob C §§10582, 10585-10587). The trustee must give notice to all beneficiaries who are receiving or are entitled to receive income under the trust or who would receive a distribution of principal if the trust were terminated at the time the notice is given. Prob C §16501(a). The trustee need not give notice to beneficiaries who consent in writing to the proposed adjustment, or to any beneficiary who is unknown to the trustee or who is known but cannot be located after reasonable diligence. Prob C §16501(b)-(c). The notice must include the information specified in Prob C §16502. For a sample form of notice, see §7.36.

Any beneficiary may object to the proposed action by mailing a written objection to the trustee within the time specified in the notice, which must be at least 45 days after the notice is mailed. Prob C §§16502(d), 16503(a). A trustee is not liable to any beneficiary for taking the proposed action if the trustee does not receive a timely written objection. If no beneficiary entitled to notice objects, the trustee is not liable to any current or future beneficiary with respect to the proposed action. However, the notice will not afford protection against a beneficiary who is a minor or an incompetent adult unless the notice has been served on the guardian or conservator of the estate of the beneficiary. Prob C §16503(b). Because there are disadvantages to sending the notice and receiving formal opposition, it will remain appropriate in many instances to first provide informal notice. If informal communications suggest that there is no opposition to the proposed transaction, the trustee may then seek to take advantage of the protection afforded by the statute—not by sending a 45-day notice but, instead, by asking the beneficiaries to consent in writing.

If the trustee receives a timely objection, a beneficiary or the trustee may petition the court to have the proposed action taken as proposed, taken with modifications, or denied. Prob C §16503(c). A trustee who decides not to implement the action must give notice to the beneficiaries of the decision and the reasons for it. Prob C §16503(d). A beneficiary may then petition the court to have the action taken. Prob C §16503(d). The beneficiary has the burden of proof, both in objecting to a proposed action and in petitioning to have an action taken. Prob C §16503(c)-(d). A beneficiary who has not objected is not estopped from opposing the proposed action in the proceeding. Prob C §16503(c).

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§8.10 H. Remedy for Exercise of Adjustment Power and Unitrust Conversion Power

In a proceeding with respect to a trustee's exercise or nonexercise of the adjustment power (see §§8.4-8.8), the sole remedy is to direct, deny, or revise an adjustment between income and principal. Prob C §16338. In *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473, the court held that a petition seeking to compel the trustees of a testamentary trust to exercise the adjustment power would constitute a contest of the will where dividends paid to the income beneficiaries were approximately 1.25 percent of the value of trust assets. In *McKenzie v Vanderpoel* (2007) 151 CA4th 1442, 61 CR3d 129, the court held that a trust income beneficiary's proposed filing of a petition to compel the trustee to exercise the adjustment power to the extent that income was less than 4 percent of the value of trust assets would violate the trust's no-contest clause. The adjustment would have had the same effect as converting the trust to a unitrust with a payout percentage of 4 percent as provided in Prob C §16336.4(e). The trustee decided not to implement the proposed adjustment after several beneficiaries objected to the trustee's notice of proposed action. See §8.9. A trustee cannot be surcharged or denied fees when the dispute relates to the exercise or nonexercise of the power to adjust or the proper level of the adjustment. This rule recognizes that any dispute concerning the exercise of the adjustment power is between the affected beneficiaries and not between the trustee and the beneficiaries. See also Prob C §16336(h).

Similarly, in a proceeding concerning the trustee's exercise or nonexercise of the unitrust conversion power (see §8.3F), the sole remedy is to direct the trustee to convert the trust to a unitrust, to reconvert from a unitrust, to change the distribution percentage, or to order any other necessary or helpful administrative procedures. Prob C §16338. As, again, is the case for the adjustment power, the Probate Code does not impose a duty on the trustee to convert or reconvert a trust or to consider a conversion or reconversion. Prob C §16336.7(a).

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II. RULES APPLICABLE TO TERMINATING INCOME INTERESTS UNDER TRUSTS

§8.11 A. Determination and Distribution of Income and Principal

Probate Code §16340 governs the distribution and determination of income and principal. It applies both to decedents' estates and to terminating income interests under a trust.

If property is specifically given to a beneficiary, that beneficiary is entitled to all of the net income and principal receipts associated with the specific property. Prob C §16340(a). The net income and principal receipts are calculated by including all of the amounts that the fiduciary receives or pays with respect to the property, regardless of whether the amount accrued or became due before, on, or after the decedent's death or the end of an income interest in a trust. Prob C §16340(a)(1).

The fiduciary may not reduce income and principal from specifically given property for payments made under Prob C §16370 (payments from income for trustee and management fees, accountings and other judicial proceedings, ordinary expenses of management, and recurring premiums) or Prob C §16371 (payments from principal for trustee fees calculated on principal, payments on trust debt, expenses of court proceedings concerning principal, premiums on policies not under Prob C §16370, taxes, and payments for environmental matters). The fiduciary also may not reduce income and principal from specifically given property to the extent that the governing instrument or Prob C §12002 (income and expenses of specifically devised property) requires payment from other property or the fiduciary recovers payment from third parties. Prob C §16340(a)(2).

A specific gift distributable under a trust carries the same benefits and burdens as a specific devise under a will as provided in Prob C §§12000-12007, notably including the right to income of the property (see Prob C §12002). Prob C §16340(a)(3).

If the beneficiary receives a pecuniary amount, the fiduciary must distribute interest or any other amount provided by the governing instrument from the remaining net income determined under Prob C §16340(c) or from principal if income is not sufficient. Prob C §16340(b).

Probate Code §16340(c) provides that the remaining net income shall be determined by (1) including in net income all income from property used to discharge liabilities; (2) paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries, court costs and other costs of administration, and interest on death taxes, to the extent that such payments do not jeopardize marital or charitable deductions; and (3) paying from principal all other disbursements made or incurred in connection with the settlement of the decedent's estate or the winding up of terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties.

After making the distributions required by Prob C §16340(b), the fiduciary must distribute the remaining net income determined under Prob C §16340(c) in the manner provided in Prob C §16341 to all other beneficiaries. Prob C §16340(d).

The Comment to Prob C §16340 notes that UPAIA distinguishes between the end of an income interest and the end of a trust. The Comment stresses that the ending of an income interest is not necessarily the end of the trust. 29 Cal L Rev'n Comm'n Reports 285 (1999).

NOTE: Some commentators promote the use of a "benefits" trust, rather than an income interest for the lifetime beneficiary, by which the income is accumulated and the trustee given discretion to pay from income and principal the amount needed for the health, education, maintenance, and support of the beneficiary. Such a provision reduces the significance of principal and income allocation issues. Others recommend the use of a unitrust when a benefits trust cannot be used, *e.g.*, because the gift to the trust is intended to qualify for the estate tax marital deduction. "Net income" is defined as the unitrust amount during any period in which the trust is being administered as a unitrust either under the unitrust conversion powers conferred by Prob C §§16336.4-16336.7 or pursuant to the terms of the governing instrument, if the unitrust amount is no less than 3 percent and no more

than 5 percent of the fair market value of trust assets. Prob C §16328. Net income and principal receipts associated with a specifically given asset may be excluded in determining the unitrust amount in a converted unitrust. Prob C §16336.4(e)(4)(B). For discussion of unitrust conversion, see §8.3F.

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§8.12 B. Distribution of Income to Residuary and Remainder Beneficiaries

Each beneficiary other than one receiving a specific or pecuniary gift is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed principal assets, using values as of the distribution dates without reduction by any unpaid principal obligations. Prob C §16341(a). If a fiduciary does not distribute all of the collected but undistributed net income to each beneficiary as of a distribution date, the fiduciary must maintain appropriate records of the beneficiaries' interest in the net income. Prob C §16341(b). The distribution date may be the date as of which the fiduciary calculates the value of the assets, if that date is reasonably near the date on which the assets are actually distributed. Prob C §16341(c).

NOTE: "Net income" is defined as the unitrust amount during any period in which the trust is being administered as a unitrust either under the powers conferred by Prob C §§16336.4-16336.7 or pursuant to the terms of the governing instrument, if the unitrust amount is no less than 3 percent and no more than 5 percent of the fair market value of trust assets. Prob C §16328. However, net income from specifically given property may be excluded in determining the unitrust amount in a converted unitrust. Prob C §16336.4(e)(4)(B). For discussion of unitrust conversion, see §8.3F.

Section 16341 retains the concept of former Prob C §16305 that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests by using asset values as of a date reasonably near the time of distribution. 29 Cal L Rev'n Comm'n Reports 289 (1999).

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III. APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

§8.13 A. When Right to Income Begins and Ends

An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest. Prob C §16345(a). An asset becomes subject to a trust if it

- Is transferred to a trust during the transferor's lifetime, on the date of transfer;
- Becomes subject to a trust by reason of a will, on the date of the testator's death; or
- Is transferred to a fiduciary from a third party by reason of an individual's death, on the date of the individual's death. Prob C §16345(b).

NOTE: In some cases, net income may be a unitrust amount. See Prob C §16328. In case of a short year, when a beneficiary's right to a unitrust amount begins or ceases, the trustee must prorate the unitrust amount on a daily basis. Prob C §16336.4(e)(6).

An asset becomes subject to a successive income interest on the day after the preceding income interest ends. Prob C §16345(c). An income interest ends on the day before an income beneficiary dies or another terminating event occurs or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income. Prob C §16345(d).

NOTE: These dates are very significant for proper allocation of principal and income. The trustee should maintain accurate and complete records of these dates, events, and circumstances.

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.14 B. Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Begins

§8.14 B. Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Begins

A trustee must allocate an income receipt or disbursement, other than one whose allocation is determined by Prob C §16340(a) (see §8.11), to principal if its due date is before a decedent dies or an income interest begins. Prob C §16346(a).

A trustee must allocate an income receipt or disbursement to income if its due date is a periodic due date and occurs on or after the date on which a decedent dies or an income interest begins. An income receipt or disbursement shall be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion accruing before the date on which a decedent dies or an income interest begins shall be allocated to principal, and the balance shall be allocated to income. Prob C §16346(b).

NOTE: Probate Code §16346 does not apply during any period in which the trust is being administered as a unitrust under Prob C §16328. See Prob C §16336.4(e)(2).

An item of income or an obligation is due on the date that the payer is required to make a payment. If a payment date is not stated, there is no due date for purposes of the UPAIA. Distributions to shareholders or other owners from an entity specified in Prob C §16350 are deemed to be on the date fixed by the entity. A due date is periodic if it must be paid at regular intervals. Prob C §16346(c).

The Comment to Prob C §16346 notes that the prior law on this matter treated the apportionment differently depending on the type of interest, *e.g.*, revocable trust or irrevocable trust. Section 16346 simplifies administration by applying the same rule to inter vivos trusts, both revocable and irrevocable, testamentary trusts, and assets that become subject to an inter vivos trust by a testamentary bequest. 29 Cal L Rev'n Comm'n Reports 291 (1999).

PRACTICE TIP: On the death of the trustor of a revocable trust that thereby becomes irrevocable, the successor trustee must investigate and establish all facts concerning dates, events, and circumstances as necessary to comply with these requirements.

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§8.15 C. Apportionment When Income Interest Ends

Except as provided in Prob C §16347(c), when a mandatory income interest ends, the trustee must pay to a surviving mandatory income beneficiary, or to the estate of a deceased mandatory beneficiary whose death causes the interest to end, the beneficiary's share of the undistributed income not disposed of under the trust. Prob C §16347(b). If the beneficiary has an unqualified power to revoke more than 5 percent of the trust, the undistributed income from the portion of the trust that may be revoked must be added to principal. Prob C §16347(c).

"Undistributed income" is net income received before the date on which an income interest ends. It does not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal. Prob C §16347(a).

When a trustee's obligation to pay a fixed annuity or a fixed fraction of the value of the trust's assets ends, the trustee must prorate the final payment. Prob C §16347(d). Similarly, when income is a unitrust amount under Prob C §16328 and the beneficiary's right to the unitrust amount ceases, the trustee must prorate the unitrust amount on a daily basis. Prob C §16336.4(e)(6).

The Comment to Prob C §16347 notes that under prior law an income beneficiary or the beneficiary's estate was entitled to receive a portion of any payment, other than dividends, that was due or had accrued when the income interest terminated. Probate Code §16347(a) changes that rule by excluding such items from undistributed income. The items affected include periodic payments of interest, rent, and dividends, as well as items of income that accrue over a longer period. The rule also applies to expenses that are due or accrued. 29 Cal L Rev'n Comm'n Reports 294 (1999).

PRACTICE TIP: During administration of the income interest, the trustee may wish to obtain confirmation of the continuing life of the income beneficiary by securing a written acknowledgment on a periodic basis.

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IV. ALLOCATION OF RECEIPTS DURING ADMINISTRATION

§8.15A A. When Default Rules Apply to Receipts

The Probate Code provides default rules for the allocation of receipts during trust administration. Prob C §§16350-16367. See Prob C §16335(a)(3). The rules are discussed in §§8.16-8.30. Additional rules govern the allocation of disbursements. Prob C §§16370-16375. See §§8.31-8.36. The default rules do not apply during any period in which the trust is being administered as a unitrust under Prob C §16328. See Prob C §16336.4(e)(2). For discussion of unitrust conversion, see §8.3F. If both the governing instrument and the Probate Code are silent about how to credit a receipt or charge a disbursement, the trustee must add the receipt or charge the disbursement to principal. Prob C §16335(a)(4).

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B. Receipts From Entities

§8.16 1. Character of Receipts

A trustee must allocate to income money received from an entity, except as otherwise provided. Prob C §16350(b). "Entity" includes a corporation, partnership, limited liability company, real estate investment trust, common trust fund, or other organization in which the trustee has an interest, with stated exceptions. See Prob C §16350(a).

The trustee must, however, allocate the following receipts from an entity to principal (Prob C §16350(c)):

- Property other than money;
- Money received in one distribution or series of related distributions in exchange for part or all of a trust's interest in the entity;
- Money received in total or partial liquidation of the entity, *i.e.*, when the total amount of money and property received by all owners, collectively, in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets (Prob C §16350(d); see discussion in §7.83); and
- Money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

NOTE: Because a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss, which is principal, the term "capital gain dividend" does not include any net short-term capital gain. Therefore, short-term capital gain dividends from a regulated investment company or a real estate investment trust are allocated to income and not to principal.

The trustee may rely on the representations of an entity about the source or character of a distribution if the representation is near the time of the distribution and made by authorized entity personnel. Prob C §16350(e). In *Hasso v Hasso* (2007) 148 CA4th 329, 55 CR3d 667, the court held that a "simple advisement" that an asset had been converted into cash for distribution did not cause the proceeds to be allocated to trust principal. The court noted that the entity's board of directors had declined an invitation by the remainder beneficiaries to declare that the distribution was made in partial liquidation.

Section 16350 applies to all forms of partnerships but does not apply to tenants in common or joint ventures. 29 Cal L Rev'n Comm'n Reports 297 (1999).

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.17 2. Distribution From Trust or Estate

§8.17 2. Distribution From Trust or Estate

A trustee must allocate to income amounts received as a distribution of income from a trust or a decedent's estate, other than an interest in an investment entity or a purchased interest, and must allocate to principal amounts received as distributions of principal from the trust estate. Prob C §16351.

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.18 3. Businesses Conducted by Trustee

§8.18 3. Businesses Conducted by Trustee

A trustee who conducts a business may determine that it is in the best interest of all beneficiaries to account separately for the business. Prob C §16352(a). A trustee who accounts separately for a business may determine the extent to which it needs working capital, the acquisition or replacement of fixed assets, and the extent to which net cash receipts are accounted for as income or principal. When the trustee sells an asset, the proceeds should be treated as principal to the extent that they are not needed for conduct of the business. Prob C §16352(b). A trustee may keep separate accounts for businesses including the following activities (Prob C §16352(c)):

- Retail, manufacturing, service, and other traditional business activities;
- Farming;
- Raising and selling livestock;
- Managing rental properties;
- Extracting minerals and other natural resources;
- Timber operations; and
- Activities to which Prob C §16366, regarding derivatives and options, applies.

The Comment to Prob C §16352 notes that these provisions are meant to give greater flexibility to a trustee who operates a business. It permits a trustee to account for the activities listed in §16352(c) as though they were held by a separate entity. It is not intended, however, to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of the UPAIA that apply to securities. Further, the trustee may account for these activities in a "subtrust." The intent is to give the trustee broad authority to select business and recordkeeping methods that best suit the activity in which the trustee is engaged. 29 Cal L Rev'n Comm'n Reports 300 (1999).

PRACTICE TIP: The trustee must maintain sufficient communication with the entity making the payments to confirm the origin of the payments.

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C. Receipts Not Normally Apportioned

§8.19 1. Principal Receipts

The following items must be allocated to principal:

- Unless otherwise allocated to income by the UPAIA, all property received from the transferor during the transferor's lifetime, a decedent's estate, a trust with a terminating income interest, or a third party payer under a contract naming the trust or its trustee as beneficiary (Prob C §16355(a));
- Unless otherwise provided by the UPAIA, money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit (Prob C §16355(b));
- Amounts recovered from third parties to reimburse the trust because of disbursements under Prob C §16371(a)(7) or for other reasons to the extent not based on loss of income (Prob C §16355(c));
- Proceeds of property taken by eminent domain, except that a separate award for loss of income is allocated to income if there was a mandatory income interest beneficiary (Prob C §16355(d));
- Net income received during a period when there is no beneficiary to whom income may be paid (Prob C §16355(e)); and
- Other receipts allocated to principal as provided in Prob C §§16360-16367 (Prob C §16355(f)).

With respect to eminent domain awards, if the award includes an amount for loss of future rent the entire award is principal unless that amount is separately stated. Comment to Prob C §16355 (29 Cal L Rev'n Comm'n Reports 303 (1999)).

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§8.20 2. Rental Property

Unless rents are accounted for as a business entity, amounts received as rent must be allocated to income. These include rents for real or personal property and amounts received for cancellation of a lease. However, amounts received as refundable deposits, including security deposits, and amounts for future rents are allocated to principal until the contractual obligations with respect to such amounts are satisfied. Prob C §16356.

The Comment to Prob C §16356 notes that some rent is really reimbursement of principal expenditures and that the trustee may wish to consider this when deciding whether to make an adjustment between principal and income under Prob C §16336. 29 Cal L Rev'n Comm'n Reports 303 (1999).

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§8.21 3. Obligation to Pay Money

Any amount received as interest on an obligation to pay the trustee money must be allocated to income without any provision for amortization of premium. This includes interest paid at a fixed, variable, or floating rate, as well as consideration for prepaying principal. Prob C §16357(a).

An amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than 1 year after it is purchased by the trustee must be allocated to principal. This includes an obligation whose purchase price or value is less than its value. However, if the obligation matures within 1 year of purchase, any amount received in excess of the purchase price must be allocated to income. Prob C §16357(b).

Section 16357 does not apply to an obligation to which Prob C §§16361-16367, governing apportionment of receipts, apply. Prob C §16357(c).

The Comment to Prob C §16357 notes that the provision setting forth the different types of interest rates makes it clear that such rates are to be subject to this section and not treated as a derivative financial instrument under Prob C §16366. The Comment also notes that the provisions of Prob C §16357(b) apply to all obligations acquired at a discount, such as U.S. treasury bills and savings bonds. The controlling rule is that, if the obligation matures in less than 1 year, the allocation is to income; if the obligation matures in more than 1 year, the allocation is to principal. 29 Cal L Rev'n Comm'n Reports 305 (1999).

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.22 4. Insurance Policies and Similar Contracts

§8.22 4. Insurance Policies and Similar Contracts

Except as provided in Prob C §16358(b), all proceeds of life insurance policies or other contracts in which the trust is named as beneficiary must be allocated to principal. Dividends are allocated to income if the premiums are paid from income and to principal if the premiums are paid from principal. Prob C §16358(a).

Under Prob C §16358(b), proceeds of contracts that insure against loss of occupancy or other use by an income beneficiary, loss of income, or, subject to Prob C §16352, loss of profits from a business, must be allocated to income.

Section 16358 does not apply to a contract to which Prob C §16361 (governing deferred compensation, annuities, and similar payments) applies. Prob C §16358(c).

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D. Receipts Normally Apportioned

§8.23 1. Insubstantial Allocations Not Required

Probate Code §§16360-16367 provide rules for the apportionment of certain types of receipts between income and principal. If a trustee determines that an allocation required under Prob C §16361, §16362, §16363, §16364, or §16367 is insubstantial, the entire amount may be allocated to principal, unless one of the circumstances of Prob C §16336(b) applies. Prob C §16360(a). These circumstances are those in which the exercise of the power to make an adjustment is prohibited.

An allocation is presumed to be insubstantial if the allocation would decrease net income by less than 10 percent or if the asset producing the receipt is worth less than 10 percent of the total value of the trust assets. Prob C §16360(b).

Section 16360 does not impose a duty on the trustee to make an allocation, and the trustee is not liable for failure to make an allocation. Prob C §16360(c).

The Comment to Prob C §16360 notes that this section is intended to relieve a trustee from making relatively small allocations, while preserving the trustee's right to do so if an allocation is large in terms of absolute dollars. Allocations under §16360 are barred under the circumstances described in Prob C §16336 in order to eliminate claims that the power in §16360 has adverse tax consequences. 29 Cal L Rev'n Comm'n Reports 307 (1999).

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.24 2. Deferred Compensation, Annuities, and Similar Payments

§8.24 2. Deferred Compensation, Annuities, and Similar Payments

Probate Code §16361 governs apportionment of deferred compensation, annuities, and similar payments. For these purposes, "payment" means one of the following (Prob C §16361(a)):

- Any payment for a fixed number of years or the lifetime of an individual because of services rendered or property transferred to the payer in exchange for future payments; or
- A payment made in money or property from the payer's general assets; or
- Any payment made from a separate fund created by the payer, regardless of the reason for the payment, including a private or commercial annuity, an individual retirement account, or a pension, profit-sharing, stock bonus, or stock ownership plan.

The allocation rule to be applied depends on whether the recipient of the payment is a marital deduction qualifying trust (see §8.24B) or some other traditional income trust (see §8.24A).

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§8.24A a. Payments Not Received by QTIP Trust

The rules described in this section determine the allocation of payments not made to a marital deduction qualifying trust, usually a QTIP trust, under Prob C §16361(d). See §8.24B.

To the extent that any portion of the payment is characterized as interest or a dividend, or an equivalent payment, it is to be allocated to income; otherwise the balance or any other payment that is not so characterized is allocated to principal. Prob C §16361(b).

If no part of the payment is characterized as interest or dividend, or an equivalent payment, and all or part of the payment is required to be made to the trustee, the trustee must allocate to income 10 percent of the part required to be made and must allocate the balance to principal. If no part is required to be made, or the payment received is the entire amount to which the trustee is entitled, the entire amount must be allocated to principal. A payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal. Prob C §16361(c).

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§8.24B b. Payments Received by QTIP Trust

If the payment is made to a marital deduction qualifying trust, such as a QTIP trust under IRC §2056(b)(7) or a general power of appointment trust under IRC §2056(b)(5), the allocation is determined under Prob C §16361(d) and depends on whether the payer provides "documentation reflecting the internal income of the separate fund" to the trustee. Prob C §16361(f)-(g). Because a QTIP trust is the form of marital trust used most often, this section refers only to QTIP trusts.

If the payer provides documentation reflecting the internal income of the separate fund, the trustee must allocate the payment to income to the extent of the fund's internal income and distribute that amount to the surviving spouse (or require the administrator to distribute this internal income to the trust on the request of the surviving spouse), with the balance to principal. If the internal income of the separate fund exceeds the payment made to the trust, the trustee must allocate principal to income to make up the difference on request and distribute that amount to the surviving spouse. Prob C §16361(f).

If the payer does not provide documentation but the trustee can determine the value of the separate fund, the internal income is deemed to equal 4 percent of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period, and the trustee must allocate the payment to income to the extent that the amount received during the same year does not exceed 4 percent of the account value, with the balance to principal; alternatively, the internal income of the fund is deemed to equal the product of the interest rate and the present value of the expected future payments, as determined under IRC §7520. Prob C §16361(g).

Subsections (f) and (g) of Prob C §16361 are designed to ensure compliance with the definition of "income" in Treas Reg §1.643(b)-1, incorporated by reference in the estate and gift tax marital deduction regulations in Treas Reg §§20.2056(b)-5(f)(1), 25.2523(e)-1(f)(1), so that a QTIP trust named as a retirement plan beneficiary qualifies for the marital deduction with respect to the plan benefits. Accordingly, these rules do not apply if the series of payments would qualify for the marital deduction as a survivor annuity under IRC §2056(b)(7)(C). Prob C §16361(e).

PRACTICE TIP: The practitioner must determine in advance, as part of the estate plan, which beneficiary to name for qualified retirement plan benefits, IRA accounts, and Keogh plans. This is especially true because of the confused state of community property interests of the nonparticipant spouse in such benefits. See California Estate Planning §21.35 (Cal CEB 2002).

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§8.25 3. Liquidating Asset

For purposes of Prob C §16362, a liquidating asset is an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration, *e.g.,* a leasehold, patent, copyright, royalty right, or right to receive payments under an arrangement that does not provide for the payment of interest on the unpaid balance. Prob C §16362(a).

A trustee must allocate to income 10 percent of the receipts from a liquidating asset and must allocate the balance to principal. Prob C §16362(b).

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.26 4. Minerals, Water, and Other Natural Resources

§8.26 4. Minerals, Water, and Other Natural Resources

Probate Code §16363(a) provides that a trustee must allocate interests in minerals or other natural resources as follows:

- If a receipt is nominal, the trustee must allocate it to income;
- If a receipt is a production payment, the trustee must allocate it to income to the extent that the agreement creating it provides for interest and must allocate the balance to principal;
- If a payment is a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental and is more than nominal, the trustee must allocate 90 percent to principal and the balance to income; and
- If a payment is from a working interest or any other interest in mineral or other natural resources not described above, the trustee must allocate 90 percent of the net amount to principal and the balance to income.

A payment received on an interest in water that is renewable is allocated to income. If the interest is not renewable, 90 percent of the payment is allocated to principal and the balance to income. Prob C §16363(b).

These rules apply regardless of whether the decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust. Prob C §16363(c).

However, the trustee may use either the current statutory rules or prior law (former Prob C §§16309-16311) to determine principal and income if the trust owned the minerals or other natural resources on January 1, 2000. Prob C §16363(d). Under prior law, the trustee could allocate the receipts entirely to income, but had discretion to allocate a specified portion of the receipts to principal to the extent of a reasonable allowance for depletion or amortization.

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.27 5. Timber

§8.27 5. Timber

Probate Code §16364(a) provides that a trustee must allocate net receipts from sale of timber and related products as follows:

- To income to the extent that the harvest does not exceed the rate of growth during a period in which a beneficiary has a mandatory income interest;
- To principal to the extent that the harvest exceeds the growth rate or the net receipts are from the sale of standing timber;
- To or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the above rules; and
- To principal to the extent that advance payments, bonuses, and other payments are not allocated under the three rules above.

In determining net receipts to be allocated under §16364(a), a trustee must deduct and transfer to principal a reasonable amount for depletion. Prob C §16364(b).

These rules apply regardless of whether a decedent or transferor was harvesting timber for the property before it became subject to the trust. Prob C §16364(c).

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§8.28 6. Nonproductive Property

If a marital deduction is allowed for a trust that contains substantial amounts of nonproductive property and the income is insufficient for the spouse to obtain the marital deduction, the spouse may require the trustee to make property productive, convert it into productive property, or exercise the power of adjustment under Prob C §16336(a) within a reasonable time. A trustee may decide which action or combination of actions to take. Prob C §16365(a). In all other cases, proceeds from the sale or other disposition of a trust asset are principal without regard to the amount of income the asset produces. Prob C §16365(b).

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§8.29 7. Derivatives and Options

For purposes of Prob C §16366, a derivative is a contract or financial instrument, or a combination of both, that gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or a group of assets. Prob C §16366(a).

Unless the trustee accounts for transactions in derivatives as a business under Prob C §16352, the trustee must allocate to principal receipts from and disbursements made in connection with those transactions. Prob C §16366(b).

If a trustee grants an option to buy property from the trust or to sell property to the trust, or acquires an option to buy property for the trust or to sell a trust asset, and the trustee or other owner of the asset is required to deliver it if the option is exercised, any amount received for granting the option is allocated to principal. Any amount paid to acquire the option must be paid from principal. A gain or loss realized on the exercise of an option, including an option granted to a settlor of the trust for services rendered, is allocated to principal. Prob C §16366(c).

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§8.30 8. Asset-Backed Securities

For purposes of Prob C §16367 an asset-backed security is an asset whose value is based on the right to receive distributions from the proceeds of financial assets that provide collateral for the security. Prob C §16367(a).

If a trust receives a payment from interest or other current return and from other proceeds of the collateral financial assets, the trustee must allocate to income that portion of the payment that the payer identifies as being from interest or other current return and must allocate the balance of the payment to principal. Prob C §16367(b).

If a trust receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, the trustee must allocate the payments to principal. If a payment is one of a series of payments that will result in the liquidation of the trust's interest in the security over more than one accounting period, the trustee must allocate 10 percent of the payment to income and the balance to principal. Prob C §16367(a).

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V. ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

§8.30A A. When Default Rules Apply to Disbursements

The Probate Code provides default rules for the allocation of disbursements during trust administration. Prob C §§16370-16375. See Prob C §16335(a)(3). The rules are discussed in §§8.31-8.36. Additional rules govern the allocation of receipts. Prob C §§16350-16367. See §§8.16-8.30. The default rules do not apply during any period in which the trust is being administered as a unitrust under Prob C §16328, and expenses that would be deducted from income if the trust were not a unitrust may not be deducted from the unitrust amount. See Prob C §16336.4(e)(2), (8). For discussion of unitrust conversion, see §8.3F. If both the governing instrument and the Probate Code are silent about how to credit a receipt or charge a disbursement, the trustee must add the receipt or charge the disbursement to principal. Prob C §16335(a)(4).

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.31 B. Disbursements From Income

§8.31 B. Disbursements From Income

Probate Code §16370 requires the trustee to make the following disbursements from income, unless they are disbursements to which Prob C §16340(c)(2) or (3) applies:

- Unless otherwise ordered by a court, one-half of the regular compensation of trustee or any person providing investment advisory or custodial services to the trustee;
- Unless otherwise ordered by a court, one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;
- All other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income; and
- All recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of an asset.

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§8.32 C. Disbursements From Principal

Probate Code §16371(a) requires the trustee to make the following disbursements from principal:

- Unless otherwise ordered by a court, one-half of the regular compensation of the trustee or any person providing investment advisory or custodial services to the trustee and one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;
- Unless otherwise ordered by a court, all of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale;
- Payments on principal of a trust debt;
- Expenses of a proceeding that primarily concerns principal, including a proceeding to construe the trust or to protect the trust or its property (see, *e.g.*, *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639 (costs of defending action to compel invasion of QTIP trust principal for benefit of surviving spouse));
- Premiums paid on an insurance policy, other than recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of an asset, of which the trust is the owner and beneficiary;
- Estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and
- Disbursements related to environmental matters.

If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee must transfer from principal to income an amount equal to the income paid in reduction of the principal balance of the obligation. Prob C §16371(b).

For discussion of allocation of environmental costs, see §§16.25, 16.26.

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§8.33 D. Transfers From Income to Principal for Depreciation

For purposes of Prob C §16372, "depreciation" means a deduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than 1 year. Prob C §16372(a).

A trustee may transfer from income to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, under generally accepted accounting principles, except in any of the following circumstances (Prob C §16372(b)):

- When dealing with the portion of real property used by or available to a beneficiary as a residence, or personal property used by or available to a beneficiary for personal use;
- During the administration of a decedent's estate;
- If the trustee is accounting under Prob C §16352 for the business in which the asset is used.

An amount transferred from income to principal need not be held in a separate fund. Prob C §16372(c).

The power to transfer funds from income to principal granted by §16372 is a discretionary power, and the trustee must comply with Prob C §16335(b). Comment to Prob C §16372 (29 Cal L Rev'n Comm'n Reports 327 (1999)).

PRACTICE TIP: In a rapidly rising real estate market, depreciation may be unwarranted. In a rapidly depreciating real estate market, depreciation may eliminate the income from the real property. Discretion in determining the "reasonable" amount of depreciation to take may require consultation with outside real estate experts.

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.34 E. Transfers From Income to Reimburse Principal

§8.34 E. Transfers From Income to Reimburse Principal

If a trustee makes or expects to make a principal disbursement described in Prob C §16373, the trustee may make a transfer from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for future disbursements. Prob C §16373(a). These principal disbursements include the following, unless the trustee expects to be reimbursed by a third party (Prob C §16373(b)):

- An amount chargeable to income but paid from principal because it is unusually large;
- A capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset;
- Disbursements made to prepare property for rental;
- Periodic payments on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payments; and
- Disbursements related to environmental matters described in Prob C §16371(a)(7).

If the asset that gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, the trustee may continue to transfer amounts from income to principal. Prob C §16373(c).

The Comment to Prob C §16373 notes that prior law permitted the trustee to spread income expenses of unusual amounts throughout a series of years. Section 16373 contains a more detailed enumeration of the circumstances in which this authority may be used and includes the express authority to use income to make principal payments on a mortgage if the depreciation charge against income is less than the principal payments on the mortgage. 29 Cal L Rev'n Comm'n Reports 329 (1999).

PRACTICE TIP: Because the trustee has discretion in making these decisions, it is important to carefully select a trustee, who then selects his or her advisors.

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§8.35 F. Allocation of Income Taxes

A tax to be paid based on receipts allocated to income must be paid from income. Prob C §16374(a). A tax required to be paid from receipts allocated to principal must be paid from principal, even if the tax is called income tax. Prob C §16374(b).

A tax required to be paid on the trust's share of a pass-through entity's taxable income must be paid as follows:

- From income to the extent that receipts from the entity are allocated only to income (Prob C §16374(c)(1));
- From principal to the extent that receipts from the entity are allocated only to principal (Prob C §16374(c)(2));
- Proportionally from principal and income to the extent that receipts from the entity are allocated to both income and principal (Prob C §16374(c)(3)); and
- From principal to the extent that the tax exceeds the total receipts from the entity (Prob C §16374(c)(4)).

After applying the tax allocation rules of §16374(c), the trustee must adjust income and principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary. Prob C §16374(d). This adjustment may require an interrelated computation of net income and taxable income.

EXAMPLE: Trust A has $50,000 of taxable income, all of which is included in trust accounting income (*e.g.*, qualified dividends). Trust A distributes one-half of its net income to Beneficiary and retains the other half. Assuming that the tax rate on trust income is 20 percent, the trust at first sight distributes $25,000 to Beneficiary and pays tax of $5000 on $25,000 of taxable income after taking a distribution deduction of $25,000. See chap 11. However, the $5000 of income tax must be allocated to income, reducing the net income of the trust to $45,000, reducing the distribution deduction to $22,500, increasing taxable income to $27,500, and increasing the tax paid to $5500. This further reduces the net income of the trust to $44,500, reducing the distribution deduction to $22,250, increasing taxable income to $27,750, increasing the tax paid to $5550, and so on. The net result is that Trust A pays income tax of $5555 on $27,777 of taxable income and distributes net income of $22,222 to Beneficiary.

Fortunately, this interrelated computation usually can be avoided by specifying in the trust instrument that the tax payment is not taken into account in calculating the net income to be paid to the beneficiary. Further, the problem does not arise in the more common case in which a trust distributes all of its net income to the beneficiary (*e.g.*, QTIP trust distribution to surviving spouse) and so pays tax only on capital gains, which are allocated to trust principal, and pays zero tax with respect to items of taxable income included in trust accounting income for which an adjustment would be required.

For purposes of allocating the tax liability between the trust and the beneficiaries, distributions to beneficiaries are considered paid in the following order from the following sources unless otherwise provided by the trust instrument, determined by the trustee, or ordered by the court: (a) net taxable income other than capital gains; (b) net realized short-term capital gains; (c) net realized long-term capital gains; (d) tax-exempt and other income; (e) trust principal. Prob C §16374.5. The provision is intended to make clear that capital gains distributed to the income beneficiary of a net income trust may be included in distributable net income (DNI) taxable to the beneficiary, as provided by Treas Reg §1.643(a)-3(b). See §11.49.

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Source: Estate Planning/California Trust Administration/8 Principal and Income/§8.36 G. Adjustments Between Principal and Income Because of Taxes

§8.36 G. Adjustments Between Principal and Income Because of Taxes

Probate Code §16375(a) provides that a fiduciary may make adjustments between principal and income to offset shifting economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arise from any of the following:

- Tax elections and decisions made by the trustee, other than marital and charitable deduction decisions;
- An income tax or any other tax incurred by the trust as a result of a transaction or distribution from the trust; or
- The ownership of an entity whose taxable income is includable in the taxable income of the estate or trust or of a beneficiary.

If an estate tax marital or charitable deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, resulting in an increase in estate taxes paid from principal and a decrease in income taxes, each estate, trust, or beneficiary that benefits from the decrease in income tax must reimburse the principal. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would otherwise have qualified for the marital or charitable deduction. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust must reimburse principal from income. Prob C §16375(b).

The Comment to Prob C §16375 notes that the purpose of this section is to give the trustee discretion to make adjustments for the effects of tax elections. The Comment also notes that Prob C §16375(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a prorata share of the S corporation's taxable income in his or her return. In this case the trustee may distribute additional cash from principal to the income beneficiary. With respect to the mandatory adjustment from income to principal to preserve an estate tax marital deduction or charitable deduction, §16375 is intended to preserve the result reached in *Estate of Harry Britenstool* (1966) 46 TC 711. 29 Cal L Rev'n Comm'n Reports 332 (1999).

PRACTICE TIP: When choosing a trustee, consider the breadth of discretion given to the trustee to make tax elections that could benefit the trustee, as a beneficiary, over the other beneficiaries.

For a table allocating receipts and disbursements under the UPAIA, see §7.43.

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9

Trustee Compensation, Attorney Fees, and Other Administrative Costs

Robert S. Tippett

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I. COMPENSATION OF TRUSTEE

§9.1 A. Determining Amount of Trustee Fee

When the governing instrument specifies the trustee's compensation, the governing instrument prevails, although the court may allow greater or lesser compensation in some circumstances. (Prob C §15680). See §9.2. Unless otherwise specified, trustee fees in the governing instrument typically cover ordinary services. Compensation for extraordinary services, therefore, is usually in addition to that specified in the governing instrument and must be specifically requested. See §9.3. When the governing instrument is silent, Prob C §15681 provides that the trustee is to be paid an amount that is reasonable under the circumstances. See §§9.4-9.16.

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons) and that will have total assets of more than $20,000 after receipt of those funds—the trust instruments must require the trustee's compensation to be in just and reasonable amounts that must be fixed and allowed by the court. Cal Rules of Ct 7.903(a)(1), (c)(8), (d).

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1. Compensation Specified in Governing Instrument

§9.2 a. Ordinary Compensation

When the governing instrument specifies the trustee's compensation, the governing instrument prevails. Prob C §15680(a). There are five general types of compensation clauses:

- The trustee is to be paid according to a formula. Most formulas are based on income, on a percentage of the value of the assets, or on a combination of income and asset value. However, a formula can include other criteria, *e.g.,* a factor based on the Consumer Price Index.
- The trustee is to be paid a "reasonable" compensation. See §§9.4-9.16.
- The (corporate) trustee is to be paid according to its published fee schedules. See §§9.4-9.16.
- The trustee is to be paid a fixed amount. This type of clause is rarely used because it does not take into account the value or complexity of the assets, the extent of the trustee's services, inflation, or increases in the trustee's costs. Indeed, corporate trustees rarely accept trusts with such a compensation clause.
- The trustee is to be paid no compensation at all. This type of provision is often used when it is anticipated that the trustee will be a family member or a beneficiary.

See Drafting California Revocable Trusts §16.20 (4th ed Cal CEB 2003) for examples of compensation clauses.

Corporate trustees routinely classify the following services as "ordinary":

- Custody of assets;
- Collection and disbursement of income (but not necessarily collections on notes, rentals, or oil interests);
- Investment review of assets;
- Purchases and sales of stocks and bonds;
- Periodic statements to beneficiaries; and
- Preparation of court accountings.

See §9.10. See also *Estate of Bissinger* (1964) 60 C2d 756, 36 CR 450.

The court may allow greater or lesser compensation than that specified in the trust instrument if the services actually performed by the trustee or the benefits accruing to the trust differ substantially from services or benefits typically covered by ordinary compensation. Prob C §15680(b). See §9.26. On extraordinary compensation, see §9.3. On compensation of public guardians and administrators, see §9.19.

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§9.3 b. Extraordinary Compensation

Unless the governing instrument provides otherwise, trustee fees specified in the governing instrument compensate the trustee for the performance of ordinary duties. A trustee seeking compensation beyond that specified in the governing instrument must usually, therefore, be prepared to demonstrate to the court that the additional compensation requested is for extraordinary duties. See *Estate of Bissinger* (1964) 60 C2d 756, 770, 36 CR 450.

Many trustees and their attorneys would consider additional compensation appropriate for handling any assets other than stocks, bonds, and cash—assets such as closely held businesses or commercial real estate, for example, which may require substantially more time, skill, or attention from the trustee than is commensurate with the compensation paid for routine services. See §§9.13-9.16. Services performed by the trustee in connection with litigation are typically extraordinary. See §§9.47, 9.50. The basis of the charges made for additional services should be logically related to the services rendered. Of course, the court has discretion to award extraordinary fees. See *Estate of Lacy* (1975) 54 CA3d 172, 180, 126 CR 432. See also *Finkbeiner v Gavid* (2006) 136 CA4th 1417, 39 CR3d 871 (trial court abused its discretion in failing to award extraordinary fees).

For procedural requirements relating to requests for extraordinary compensation, see §9.24. For Petition and Order forms, see §§9.57-9.60.

The trustee should keep a detailed record of services for which extraordinary compensation will be sought, including a description of the service and the time required to perform it. Corporate fiduciaries generally have procedures for maintaining time records, determining what are ordinary services covered by their published fee schedules, and maintaining records of extraordinary services. It may be necessary, however, to explain the differences between ordinary and extraordinary services in some detail to the individual trustee, depending on the trustee's level of sophistication. In addition, it is good practice for the trustee to advise the beneficiaries in advance of the reasons for charging additional compensation.

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§9.4 2. Compensation Not Specified in Governing Instrument

Most trust instruments—the vast majority—are either silent on the subject of compensation or, at most, state that the trustee is entitled to reasonable compensation. Probate Code §15681 provides that, when the instrument is silent, the trustee is entitled to compensation that is reasonable under the circumstances.

For unsupervised trusts that do not specify the trustee's compensation (*i.e.,* do not specify "ordinary" compensation), the distinction between ordinary and extraordinary trustee fees does not have any particular legal significance because all compensation for such trusts must be reasonable under the circumstances, regardless of whether the services performed were ordinary or extraordinary. Nonetheless, in determining the appropriate fee for a particular service, reference may be made to customary practice to determine whether that service is typically covered by basic fee schedules (*i.e.,* is ordinary) or is typically compensated through an additional charge (*i.e.,* is extraordinary).

For court-supervised trusts that do not specify compensation (*i.e.* do not specify "ordinary" compensation), the distinction between ordinary and extraordinary services may have some legal significance if the local court has published guidelines setting trustee compensation. In such cases, the guidelines implicitly cover compensation for ordinary services, and the trustee may request additional compensation for extraordinary services. See §§9.3, 9.17.

PRACTICE TIP: In order to minimize disagreements with the beneficiaries, the trustee should always explain the method of compensation at the start of the relationship. Even when no court approval of extraordinary compensation is sought, the trustee should keep detailed records in case he or she is called on to justify the reasonableness of compensation requested, either informally to the beneficiaries or in a court proceeding brought by a beneficiary to object to the trustee's compensation.

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§9.5 a. Factors in Determining Reasonable Compensation

The court may consider the following factors in determining reasonable compensation (see Cal Rules of Ct 7.776):

- The gross income of the trust;
- The success or failure of the trustee's administration, as measured, *e.g.,* by the growth in value of the investments;
- Any unusual skill, expertise, or experience that the trustee has brought to the position, *e.g.,* investment management expertise;
- The "fidelity" or "disloyalty" shown by the trustee (see §9.32);
- The amount of risk and responsibility assumed by the trustee, as measured, *e.g.,* by negotiation of oil leases or management of a large office building;
- The time that the trustee spent performing trust duties;
- The custom in the community, including the compensation allowed to trustees by settlors or courts and the fees charged by corporate trustees; and
- Whether the work was routine or required more than ordinary skill and judgment.

For application of these factors, see *Estate of McLaughlin* (1954) 43 C2d 462, 467, 274 P2d 868; *Estate of Gump* (1982) 128 CA3d 111, 180 CR 219; *Estate of Nazro* (1971) 15 CA3d 218, 93 CR 116. See also *Cagnolatti v Guinn* (1983) 140 CA3d 42, 189 CR 151, for the general proposition that the court may consider the trustee's management of the trust property in determining the appropriate compensation.

The California Supreme Court has held that it is not necessarily improper for a trustee to receive dual compensation both as a trustee and as an officer and director of a company owned by the trust. *Estate of McLaughlin* (1954) 43 C2d 462, 470, 274 P2d 868. But see *Estate of Bonaccorsi* (1999) 69 CA4th 462, 81 CR2d 604.

The case law also gives some indication of what constitutes unreasonable compensation. In *Estate of Feraud* (1979) 92 CA3d 717, 154 CR 889, the court held that, when the trust's primary asset was stock in the settlor's company, it was unreasonable for the trustees, who were also the principal officers and directors of the company, to base their trustee compensation on the company's gross sales, which were high, rather than on its net profits, which were unimpressive and which were a better indicator of the trustees' performance.

The importance ascribed to the various factors listed above will vary substantially from case to case. For instance, when the principal asset in a trust is a closely held company, the trustee's sole investment decision may be whether to retain the company in the trust or sell it in order to diversify the trust assets. Even when the trust instrument relieves the trustee of liability for retaining the company in the trust, an argument can be made that the trustee should be entitled to a full fee as compensation for monitoring the company's performance and electing the company's directors.

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§9.6 b. Trustee Compensation in Practice

Corporate Trustees. Corporate trustees usually adhere to their own published fee schedules, which can be obtained at their offices, but those schedules are neither constant nor binding. See *Estate of Nazro* (1971) 15 CA3d 218, 93 CR 116, in which the court held that courts should not unquestioningly respect published fee schedules of institutional trustees. Fees for unusual assets, such as closely held companies, will usually be negotiated on a case-by-case basis, depending on the particular circumstances. See §9.16. In addition, corporate trustees sometimes negotiate downward from their published schedules, particularly for very large trust accounts, for long-standing clients, or for clients with multiple trust accounts.

Private Professional Trustees. Fees charged by private professional trustees are typically lower than those charged by corporate trustees, on the theory that private professional trustees must hire and compensate investment advisors and other professionals that corporate trustees often have on staff. Because the fees of these outside professionals are usually paid directly from the trust, the fees of the private professional trustee are, in general, correspondingly lower to reflect these other costs.

Nonprofessional Trustees. Nonprofessional trustees often use the fees charged by corporate trustees and private professional trustees as an upper limit on their own fees. The reason for this is two-fold. First, nonprofessional trustees, who are often family members, usually lack the experience, resources, and qualifications to manage the trust as effectively as professional trustees. Second, because most nonprofessional trustees lack the resources that professional trustees possess, nonprofessional trustees must rely more heavily on outside advice and assistance from investment advisors, accountants, and attorneys. Arguably, the nonprofessional trustee's fees should be discounted by the amount of fees that are paid to such third parties to perform basic services. On the other hand, family trustees may bring to their fiduciary responsibilities an intimate familiarity with the history of the trust and the circumstances of the beneficiaries, and perhaps a personal stake in the trust as well, that may enable them to exercise more effective stewardship over the trust than a corporate or private professional trustee. This may be particularly true when the family trustee is a qualified professional accustomed to dealing with financial and legal issues. Of course, many family trustees do not seek compensation at all.

The methods and rate structures typically used by California corporate trustees and private professional fiduciaries for determining trustee fees charged by them for various services and types of assets are described in §§9.7-9.16. The ranges of fees cited in the following sections are merely approximations of the fees customarily charged by trustees at the time this chapter was written. The methods described are not legal standards; they are merely common practice. As such, however, they may suggest benchmarks for what constitutes "reasonable" compensation.

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(1) Basic Fee Schedule

§9.7 (a) Fees Calculated as a Percentage of Principal

Corporate trustee fees on the first $1 million of market value of trust assets tend to range from 1.0 to 1.30 percent. Fees on the second $1 million tend to range from 0.70 to 1.25 percent. Fees on the next $3 million range from 0.50 to 0.90 percent. Fees for assets over $5 million range from 0.35 to 0.65 percent. For trusts over $20 million, fees can get as low as 0.20 percent. When the trust assets are invested in the corporate trustee's common trust funds or proprietary mutual funds, the rates are sometimes reduced. See §9.11.

Fees charged by private professional trustees are customarily at the low end of these ranges, if not lower, on the theory that they must hire and compensate investment advisors and other professionals and that the fiduciary fees should be correspondingly reduced.

If court approval is required, the trustee's attorney should consult local court rules and published guidelines. See §9.17. Where local court rules prescribe fee guidelines, they are often expressed as a percentage of the market value of the trust assets, (*e.g.,* 1 percent per year). Some courts express the fees as a percentage of the trust's annual income (*e.g.,* 6 percent of annual income).

NOTE: Fees calculated as a percentage of principal may be subject to minimums ranging from $2500 to $10,000 and, in some cases, much higher for corporate trustees that primarily serve wealthy clients. The minimum fees may be lower for assets invested entirely in a corporate trustee's proprietary mutual funds or common trust funds.

NOTE: It is not uncommon for a trustee to charge an annual base fee of $1000 to $3000, in addition to the fees that are calculated as a percentage of the market value of trust assets. Annual base fees are more common when a trust has been divided into several sub-trusts. The asset value of the sub-trusts may be aggregated for purposes of the fee schedule calculations, but the annual base fee will be charged to each sub-trust to cover the costs of its administration.

Occasionally, a corporate or private professional trustee will be used for the sole purpose of winding up a trust, *e.g.,* when the trust terminates at the death of the family member who had been serving as trustee. In such cases, the private trustee may charge a higher fee for his or her responsibilities (*e.g.,* one-half of the statutory probate fees found in Prob C §10800).

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§9.8 (b) Lower Fees for Directed Accounts

Corporate trustees may charge substantially lower fees—as much as 50 percent lower than fees calculated as a percentage of principal— for directed accounts, *i.e.,* accounts for which the settlor or other designee manages the investments but for which the trustee performs most of the other fiduciary functions. In such situations, the trust instrument may absolve the trustee of responsibility for making investment decisions.

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§9.9 (c) Timing of Fees; Date for Calculating Fair Market Value

Most trustees take their fees either monthly or quarterly in arrears. Where the fees are calculated as a percentage of principal, market value is typically determined as of the last business day of the preceding period, although some are valued only yearly. It may be preferable, though less common, to calculate the average market value of the assets during the preceding period. This method may smooth out market fluctuations during volatile periods. See §9.22 regarding when compensation may be taken for court-supervised trusts. See also §9.21 regarding unsupervised trusts.

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§9.10 (d) Services Included in Basic Fees

The fees described in §§9.7-9.9 are typical of those charged by corporate trustees for fully managed trust accounts. These fees usually cover services pertaining to custody of assets, investment management, collection and distribution of income, and reporting to the beneficiaries. Some corporate trustees charge additional fees for in-kind distributions of securities to cover the costs of coordination with transfer agents. In-house preparation of tax returns may be included in the basic corporate trustee fee schedule, although some corporate trustees will charge $300-$500 per set of federal and state returns. When outside accountants and other professionals are used, which is often the case with more complicated returns, such costs are usually in addition to the basic fee schedule. Outside professionals are usually hired to prepare court accountings, when needed, and their costs are usually in addition to the basic fee schedule.

As noted above, most private professional trustees employ financial advisors and other professionals to provide services that corporate trustees provide in-house. Although the Probate Code does not require a corresponding reduction in fiduciary fees, most private professional trustees charge less than corporate trustees in recognition of the added fees of these advisors and consultants. Some local court rules provide that, when basic bookkeeping services are performed by a third party for an individual trustee, the trustee's basic compensation will be reduced by the fees paid to the third party. Most private trustees hire outside professionals for all tax services, and the costs of such professionals will be charged to the trust. Some, but not all, private trustees charge for their own time spent coordinating tax matters with the professionals.

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(2) Fees for Managing Common Trust Funds and Individual Securities

§9.11 (a) Corporate Trustees

Traditionally, most large corporate trustees managed their own nonportable common trust funds. These were, in essence, mutual funds that were exempt from securities regulations and whose only investors were the individual trusts being managed by the corporate trustee. Particularly for smaller accounts, trustees often preferred to invest trust assets in their common trust funds, as opposed to holding individual securities in trusts, in order to facilitate management, asset allocation, and investment diversification. Because the common trust funds were nonportable, beneficiaries would have to be cashed out of them when the trust terminated, which often triggered substantial capital gains taxes. Today, however, many corporate trustees operate publicly traded proprietary mutual funds. Beneficiaries of terminated trusts, therefore, can keep their interests invested in the trustee's mutual funds even after their interests in the trust have been distributed to them.

Some trustees will charge comparatively lower rates than those shown on their basic fee schedule if all of the trust assets are invested in the trustee's proprietary mutual funds or common trust funds, or comparatively higher rates if some of the trust assets are invested in individual securities. Many trustees, however, draw no such distinction. In addition, a set-up fee will sometimes be charged to cover the costs of registering individual securities in the name of the trustee. When trust assets are invested in nonportable common trust funds, there may be a fee on termination of the trust.

When a trust does contain individual securities, brokerage commissions will often be charged to the trust in addition to the standard trustee fees; in the case of corporate trustees, however, these commissions will usually be at low institutional rates. Fees on funds invested in a corporate trustee's proprietary mutual funds may be charged to the trust, but some trustees rebate such fees.

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§9.12 (b) Private Professional Trustees

Many private professional trustees hire financial advisors whose fees are charged to the trust, and the trustee's fee is often reduced by the amount of the advisor's fee in such cases. Private professional trustees often invest in low-turnover mutual funds. When the trust contains individual securities, brokerage commissions will be charged to the trust. When the trustee or financial advisor has established relationships with brokerage firms, such commissions may be at lower institutional rates.

Private professional trustees often also charge a set-up fee to cover the costs of registering the securities in the name of the trustee. Sometimes the fee is charged on a per-asset basis (*e.g.,* $25 per asset) and sometimes the trustee will charge a higher basic fee (*e.g.,* 1.25 percent of trust assets) for the first year.

Some private professional trustees, as well as other trustees, charge additional fees for in-kind distributions of individual securities to cover the costs of coordination with transfer agents.

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(3) Fees for Managing Real Estate

§9.13 (a) Investment Real Estate

Corporate trustees who are required to manage investment real estate usually calculate their fees in one of three ways:

- They may simply include the market value of the property in the trust's assets for purposes of applying the basic rate schedule. This ad valorem fee may or may not accompany a base fee.
- They may apply a different percentage to the property's value (*e.g.,* 1.3 percent per year).
- They may calculate the fee as a percentage of the gross rental income, usually about 6 percent per year.

Most trustees apply these fees in lieu of the basic rate schedule that would otherwise apply to the real estate in the trust. However calculated, the foregoing fees would typically include collection of rents, payment of real property taxes and other miscellaneous expenses, and a periodic physical inspection of the property. Additional compensation would be expected, however, for time and effort expended negotiating leases, evicting tenants, handling zoning or building code problems, dealing with casualty losses, or undertaking construction and renovations. See *Estate of Lacy* (1975) 54 CA3d 172, 126 CR 432.

Some trustees charge an additional fee for leasing the property. These fees are expressed either as a percentage of the rent (*e.g.,* 0.50 percent of the yearly rent or 50 percent of the first month's rent) or as a flat dollar amount (*e.g.,* $500 per lease). Some trustees will charge an hourly rate (*e.g.,* $120 per hour) for time spent leasing the property.

If an outside manager handles most of the management functions for investment real estate, the corporate trustee's fees will probably be lower than if it is required to manage the real estate itself, and the cost of the manager will be in addition to these reduced trustee's fees. Private professional fiduciaries rarely manage real estate themselves. They typically include the value of the real estate in the trust's total asset value when applying the basic fee schedule, and then charge the manager's fees to the trust.

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Source: Estate Planning/California Trust Administration/9 Trustee Compensation, Attorney Fees, and Other Administrative Costs/§9.14 (b) Personal Residence

§9.14 (b) Personal Residence

When the trust holds title to a personal residence, most corporate trustees and private professional fiduciaries charge a flat dollar amount (typically $500-$750) per year in lieu of applying the basic fee schedule to the value of the home. Some trustees will apply the basic rate schedule to the residence, but at a value well below fair market value. This assumes that the trustee would merely hold title to the residence and would be responsible only for limited ministerial functions such as paying taxes and insurance.

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Source: Estate Planning/California Trust Administration/9 Trustee Compensation, Attorney Fees, and Other Administrative Costs/§9.15 (c) Purchases, Sales, and Transfers

§9.15 (c) Purchases, Sales, and Transfers

Some trustees charge a percentage of the sale price for purchases and sales of trust real estate. There is little uniformity as to these rates, however. They range from 0.50 percent of the sale price to 6 percent or higher. The trustee may charge relatively less if a broker is involved and relatively more if not. Alternatively, some private professional trustees will charge for their services in connection with purchases and sales on an hourly basis.

Some trustees charge a set-up fee to cover the cost of transferring title to real estate to the trustee as well as distribution fees for in-kind distributions of real estate. Such fees are typically $250-$500 per property.

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§9.16 (4) Fees for Managing Other Assets

Life Insurance Trusts. For life insurance trusts, an annual corporate or private professional trustee fee of about $500-$1500 is typical. Additional fees may be charged for the purchase and transfer of policies and the holding of multiple policies.

Oil and Gas Interests. There is very little uniformity in the fees corporate trustees charge for oil and gas interests in trusts. Some trustees apply their basic rate schedule to the value of the interests. In so doing, some will value the interests at a premium over their market value (*e.g.,* 500 percent of their market value). Others charge a percentage of the gross income (often 5-7 percent). Still others may charge a flat fee (*e.g.,* $35) for holding title to non-income-producing mineral rights. To the extent extraordinary responsibilities are required, additional fees would be charged.

Assets Entailing Extraordinary Responsibilities. When the trust holds an ongoing business or other assets that require extraordinary management responsibilities, most trustees will try to negotiate a fee in advance, expressed as either a flat dollar amount, a percentage of fair market value, or a percentage of the increase in the value of the assets resulting from the extraordinary service. The fee will normally reflect the amount of the trustee's time and effort that will be required, and the responsibility and risk involved. When unexpected issues arise that fall beyond the scope of the negotiated fee, an hourly rate will often be charged for the time expended by corporate trust officers and other trustee personnel. These hourly rates are typically $100-$150. Hourly rates of private professional fiduciaries tend to fall in this same range.

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§9.17 c. Consulting Local Rules and Court Guidelines

When court approval is needed for the trustee's compensation, local court rules should be consulted. Some counties publish guidelines for ordinary compensation in the local probate rules; some may instead publish guidelines in probate policy memoranda; and some do not publish guidelines at all. A court that has published guidelines regarding the level of trustee compensation will adhere to those guidelines for court-supervised trusts unless circumstances justify deviation. The court will usually be heavily influenced by the guidelines with respect to unsupervised trusts for which the trustee seeks court approval of compensation, or when a beneficiary has objected to the compensation taken.

Local court-published fee guidelines are usually expressed as a percentage of the market value of the trust assets, often 1 percent per year. Some courts express the fees as a percentage of the trust's annual income (*e.g.,* 6 percent of annual income). Many courts award the local guideline fee without requiring any documentation from the trustee on services rendered. If additional compensation is requested, however, the trustee must describe in detail the services rendered and the amount of compensation requested, either in the petition for compensation or by a separately filed affidavit. See §§9.3, 9.24.

Local court rules also prescribe the appropriate procedures for requesting approval of compensation, such as the timing of requesting compensation, and the form and contents of the petition. See §9.22.

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§9.18 3. Compensation of Cotrustees

Provisions of the governing instrument, if any, control apportionment of the trustee's fee among cotrustees. If the governing instrument does not contain an apportionment clause and the cotrustees cannot reach an agreement on the allocation of compensation, then Prob C §15683 provides that compensation should be apportioned among the trustees according to the respective services rendered by each. See *Estate of McLaughlin* (1954) 43 C2d 462, 274 P2d 868.

For unsupervised trusts, a petition may be brought under Prob C §17200(b)(9). For supervised trusts, allocation ordinarily is made at the time of the hearing on the accounting when the court is requested to allow compensation. In the fee petition or accounting, each trustee should present an itemized statement of services rendered. The petition or accounting should inform the court if one or more trustees has rendered extraordinary services.

PRACTICE TIP: It should be noted that corporate trustees and private professional trustees usually expect to receive the full court-guideline trustee's fee or the full fee stated in their fee schedules. They accordingly consider any compensation requested by an individual cotrustee to be extra, on the theory that the cotrustee(s) are usually family members and it is the corporate or professional trustee who performs most of the work and assumes most of the responsibility. Occasionally, a corporate or professional trustee will even charge an additional fee if it is required to consult with cotrustees before making investment decisions. When a corporate trustee is acting with an individual cotrustee, therefore, it is important that both parties clearly understand the fee arrangements at the outset. The corporate trustee's expectations notwithstanding, the court may determine that the local guideline fees should be allocated among all cotrustees in proportion to their respective services.

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§9.19 4. Compensation of Public Guardian or Administrator Appointed as Trustee

A public guardian or public administrator may be appointed to fill a vacancy in the office of trustee without consent only if the court finds that no other qualified person is willing to act as trustee, and the public administrator may be appointed without consent only if the trust is to be distributed outright in not more than 6 months. Prob C §15660.5. Notwithstanding the terms of the trust, a public guardian or administrator appointed as trustee is entitled to compensation as provided in Prob C §15680 (see §9.2) or as provided to a personal representative, based on the fair market value of trust assets (see Prob C §§15800-15801) with a $1000 minimum, depending on the nature of the trust. Prob C §15688(b). The public guardian or administrator is also entitled to reimbursement for reasonable expenses incurred in the administration of the trust. Prob C §15688(a).

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§9.20 B. Reimbursement of Trustee for Costs

The trustee is entitled to reimbursement from the trust for expenditures paid from its own funds that were properly incurred in administering the trust, as well as for expenditures that were not properly incurred to the extent that such expenditures benefited the trust. Prob C §15684. In *Conservatorship of Lefkowitz* (1996) 50 CA4th 1310, 1314, 58 CR2d 299, the court stated that "a trustee may not be indemnified for an expense unless the trustee subjectively believed that the expense was necessary or appropriate to carry out the purpose of the trust and that belief was objectively reasonable."

The trustee has an equitable lien on the trust property for the amount of advances, plus interest on such advances, made for the protection of the trust, and for expenses, losses, and liabilities sustained in the administration of the trust or because of ownership or control of trust property. Prob C §15685; Restatement (Second) of Trusts §244, comment c (1959). The equitable lien applies to assets in the trust but ceases on distribution, even though the right of indemnification continues. If the trustee is entitled to indemnity out of a trust estate for expenses incurred in the administration of the trust estate and conveys the trust estate to the beneficiary without deducting the amount to which the trustee is entitled, the trustee is entitled to indemnity from the beneficiary personally. *Kasperbauer v Fairfield* (2009) 171 CA4th 229, 88 CR3d 494.

See §§9.57-9.60 for Petition and Order forms.

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C. Procedure for Taking Trustee's Fee

§9.21 1. Fee Procedure for Unsupervised Trusts

If the governing instrument provides a schedule of times for taking fees, it must be followed. If not, the trustee may take fees whenever he or she believes it is appropriate to do so. Corporate and private professional trustees generally take fees according to a set timetable, most often monthly or quarterly. Individual nonprofessional trustees are more likely to take fees annually or only after certain specific services have been performed. As a practical matter and from the standpoint of good client relations, the trustee should probably take fees only for services already rendered, rather than in advance.

Even for unsupervised trusts, trustees have a duty to account to beneficiaries. Prob C §16062. The account must show the trustee's compensation for the last complete fiscal year of the trust or since the last account. Prob C §16063(a)(3).

Although no court order is needed to allow the trustee compensation from an unsupervised trust, if there is friction between the trustee and the beneficiaries it may be wise for the trustee to seek an order fixing compensation, or at least explain the basis of compensation to the beneficiaries, rather than wait until the beneficiaries ask for court review.

Beneficiaries who believe the trustee's compensation is not reasonable may petition the court for relief. Under Prob C §17200(b)(9), the superior court has jurisdiction over matters of compensation when an action is brought by the trustee or beneficiary of an unsupervised trust, provided that all persons interested in the trust are made parties to the action.

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2. Fee Procedure for Court-Supervised Trusts

§9.22 a. Obtaining Court Approval

Generally speaking, a court-supervised trust is either a testamentary trust created by a pre-July 1, 1977, will that has a noncorporate trustee, or a trust that, by its terms, requires court supervision. Prob C §17300. In *Estate of Goddard* (1984) 157 CA3d 340, 203 CR 623, the court held that a trust was not subject to continuing court supervision merely because it provided that the trustee was to receive reasonable compensation to be fixed by the court for its services. Court-supervised testamentary trusts are governed by Prob C §§17300-17354. Section 17301 states that the court in which the decedent's estate was administered retains jurisdiction for any of the purposes of Prob C §17200, including fixing and allowing compensation.

The trustee of a court-supervised trust should set forth any request for compensation either in the petition for settlement of an accounting or in a separate petition submitted specifically for this purpose. Some local court rules express a preference for determining fees at the time an accounting is considered.

Trustees of court-supervised trusts should always obtain court approval before taking compensation. A trustee who takes compensation before obtaining a court order does so at his or her own risk, even though some local court rules may allow a trustee to take fees subject to later court ratification. See *Estate of Gilfillan* (1978) 79 CA3d 429, 144 CR 862. If commissions or fees are paid without a court order, the court may disallow all or part of the amount taken and surcharge the trustee or award the trust interest for the loss of use of the funds that were paid out as compensation. See *Estate of Gilfillan* (1978) 79 CA3d 429, 437, 144 CR 862, 867; *Estate of Willardson* (1951) 101 CA2d 777, 226 P2d 369.

See §§9.57-9.60 for Petition and Order forms.

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§9.23 b. Taking Periodic Compensation

If the court has fixed an amount of periodic compensation for the future, the compensation may be taken without further court order for however long and at whatever periodic intervals the court, in its order, has determined is proper. See Prob C §15682. Although the trustee's attorney may typically request the court to allow the trustee "reasonable compensation" in the future, rather than specify a new set amount, some practitioners specify in the petition the amount (or a formula) that the trustee intends to charge in the future. Doing so reduces questions from both the court and the beneficiaries and gives the trustee prior court approval for the proposed compensation.

In the case of an institutional trustee, language recommending that the institution be allowed to charge according to its "published fee schedules in effect at the time" for similar accounts will serve the same purpose. One way in which the practitioner can assist the court is by having prior approval of the requested compensation from income beneficiaries (as defined in Prob C §16325) and remainder beneficiaries, including, if necessary, a guardian ad litem to represent minor, unborn, unascertained, and contingent beneficiaries.

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Source: Estate Planning/California Trust Administration/9 Trustee Compensation, Attorney Fees, and Other Administrative Costs/§9.24 c. Requesting Extraordinary Compensation

§9.24 c. Requesting Extraordinary Compensation

Local court rules often require that a request for extraordinary compensation set forth the facts on which the request is based and, for each item, give a detailed description of the services provided, including dates, and specify the reason for the work, the complexity of the issues involved, the time spent, the hourly rate of each person whose time was charged to the matter, the results achieved, and the benefit to the trust. Most courts also require that the caption of the petition and the notice of hearing clearly indicate that extraordinary compensation is being sought. Whether or not required by the local rules, it is prudent to provide all of this information to the court.

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§9.25 3. Changes in Trustee's Fee

Probate Code §15686 governs any increase in the trustee's fee, which refers to items such as the trustee's periodic base fee, rate of percentage compensation, minimum fee, hourly rate, and transaction charge, but does not include fees for extraordinary services. Prob C §15686(a). While it may appear on its face that the section pertains only to corporate trustees, it applies to both corporate and individual trustees.

A trustee desiring an increased fee must provide 60 days' written notice of that increased fee to all beneficiaries entitled to notice under Prob C §16062, all beneficiaries who received the trustee's last account, and all beneficiaries who have previously made a written request to the trustee for a notice of increased trustee's fees and have given an address for receiving notice by mail. Prob C §15686(b). If, within the 60-day period, the beneficiary files a petition under Prob C §17200 for review of the increased trustee's fee or for removal of the trustee and serves a copy of the petition on the trustee before the expiration of the 60-day period, any increase in the trustee's fee does not take effect as to that particular trust until otherwise ordered by the court or the petition is dismissed. Prob C §15686(c).

While the requirement of Prob C §15686 clearly applies to unsupervised trusts, it is unclear whether it also applies to court-supervised trusts. Although the beneficiaries of supervised trusts are, in any event, entitled to receive 30 days' notice of the hearing on any request for increased fees under Prob C §§17200(b)(9), 17203, it is probably prudent for the trustee of a court-supervised trust to provide written notice of the proposed increase to the beneficiaries at least 60 days before the hearing, which will often be before the hearing date is set.

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§9.26 4. Modification of Compensation Provisions in Governing Instrument

Probate Code §15680(b) provides that on a proper showing the court may fix or allow greater or lesser compensation than that provided for in the governing instrument. The statute contemplates that an allowance may be made when:

- The trustee's duties are substantially different than contemplated when the trust was created;
- The compensation in the instrument is inequitable or unreasonably low or high; or
- There are extraordinary circumstances calling for equitable relief.

The court, for example, may allow greater compensation if the trust's compensation provisions were considered sufficient 20 years ago but are no longer reasonable in today's economic environment; when the asset composition of the trust has changed so that much more time and expertise are now required of the trustee to administer the trust properly; or when an original trustee who was willing to serve for little or no compensation is replaced by a successor trustee—individual or corporate—who expects to be reasonably compensated for services rendered. See *Estate of Taylor* (1970) 6 CA3d 16, 85 CR 474.

Probate Code §15680(c) provides that an order fixing or allowing greater or lesser compensation applies only prospectively to actions taken after the order is issued.

If a trust contains a fee clause that a potential successor trustee believes will provide inequitably low compensation, the trustee should either condition acceptance on modification of the clause by the court or should refuse to accept the appointment until the current trustee has obtained a modification. The court may fix an amount of periodic compensation under Prob C §15680 to continue for as long as the court determines is proper. Prob C §15682. See also *Estate of Gilfillan* (1978) 79 CA3d 429, 144 CR 862.

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§9.27 5. Waiver of Trustee Fees

When a trustee is a family member, the natural inclination is often to decline to take compensation for fiduciary services rendered. If the trust specifies compensation, however, care must be taken that the waiver of trustee fees does not produce unintended gift tax consequences. See §9.30.

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D. Allocation of Compensation to Principal and Income

§9.28 1. Payment From Source Specified in Governing Instrument

The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) governs every trust existing on or after January 1, 2000, except as the trust instrument expressly provides to the contrary. Prob C §16339.

If the trust instrument specifies a method of allocation, as between income and principal, the Act provides that the trustee shall pay the trustee's compensation from the source specified in the trust instrument, even if the Act identifies a different source of payment. Prob C §16335(a)(1). If the trust instrument gives the trustee discretion to determine the source of payment, the trustee may exercise that discretion even if it produces a result different from that specified by the Act. Prob C §16335(a)(2). The Act does require, however, that the trustee exercise its discretion impartially, unless the trust instrument instructs the trustee to favor one or more beneficiaries, *e.g.,* when the settlor's surviving spouse is to be favored over the settlor's children or the settlor's children are to be favored over more remote descendants. Prob C §16335(b). See also Prob C §16003.

If the trust instrument neither specifies the source of payment nor gives the trustee discretion in this regard, the source specified in the Act prevails. Prob C §16335(a)(3). The Act provides that the trustee's regular compensation is to be paid one-half from income and one-half from principal, except as otherwise ordered by the court. Prob C §§16370(a), 16371(a)(1). The rationale for this division is that the trustee's routine services benefit both income and remainder beneficiaries equally. Even an equal division, however, does not ensure equitable treatment. The income beneficiary loses not only a portion of income, depleted to pay fees, but also the income-producing potential of the portion paid from principal. The Act is unclear about what standards the court should apply in ordering a different allocation from that specified in the Act. Presumably, the court may make adjustments to ensure that the allocation is equitable under the circumstances and treats all beneficiaries impartially.

All of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination is to be paid from principal, except as otherwise ordered by the court. Prob C §16371(a)(2). Presumably, the reference to "distribution" here refers to distribution of corpus and not distribution of income. For all other matters, the Act contains a default provision in Prob C §16335(a)(4), requiring the trustee to allocate to principal any item on which both the trust instrument and the Act are silent.

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§9.29 2. Allocation of Extraordinary Compensation

Extraordinary compensation that involves both the income and remainder interests is chargeable one-half to income and one-half to principal, except as otherwise ordered by the court. Prob C §§16370(b), 16371(a)(1). When an item of extraordinary compensation involves the income and remainder interests disproportionately, it would seem that the court has the authority to apportion the compensation equitably between them. The Act does not expressly give the trustee the authority to make that determination. In such a case, the Act seems to require that the trustee request the court to approve an equitable allocation under Prob C §17200(b)(9).

One would expect that items of extraordinary compensation that pertain only to the income interest would be allocated to income, but the Act is not clear on this point. Section 16370(c) does provide that all other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including expenses of a proceeding or other matter that primarily concerns the income interest, are allocated to income; however, extraordinary compensation is not an ordinary expense. In such a case, the trustee may want to request the court, under Prob C §17200(b)(9), for authority to charge the item against income.

Items of extraordinary compensation that pertain to principal are to be allocated to principal. Expenses of a proceeding that primarily concerns principal, including a proceeding to construe the trust or to protect the trust or its property and disbursements related to environmental matters, are allocated to principal. Prob C §16371(a)(4), (7).

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§9.30 E. Tax Considerations in Fee Structure

The manner in which the trustee's compensation is structured may present potential estate, gift, and income tax opportunities, as well as potential pitfalls, when the trustee and the beneficiaries are members of the same family. In such cases, the tax ramifications of trustee compensation should always be considered when determining whether the trustee should take fees and, if so, how much.

When, for instance, the trustee is a member of the older generation and does not need the compensation for his or her services, it may be wise family tax planning to forgo the trustee fees and allow the funds to grow in the trust for the benefit of the younger generations rather than be included in the trustee's taxable estate at death. Care should be taken, however, to ensure that, by waiving trustee's fees, the trustee is not deemed to have received taxable income in the amount of a reasonable trustee fee and then to have made a taxable gift to the trust beneficiaries in the same amount. Gift tax treatment can generally be avoided if the trustee executes a formal waiver of fees soon after taking office. See Rev Rul 66-167, 1966-1 Cum Bull 20, Rev Rul 64-225, 1964-2 Cum Bull 15, and Rev Rul 70-237, 1970-1 Cum Bull 13. A detailed discussion of the tax rules governing such waivers is beyond the scope of this treatise.

When the trustee is a remainder beneficiary and the trust will be subject to a 55-percent estate or generation-skipping transfer tax at the death of the income beneficiary, it may be wise tax planning to pay the trustee a generous fee, because the trustee will pay tax on such compensation at the comparatively low ordinary income rates and the trust will receive a deduction for the compensation paid. It is important, however, to ensure that the trustee's compensation does not exceed that which is reasonable. In IRS Technical Advice Memorandum 200014004, the Service ruled that, when the income beneficiary acquiesced in trustee fees for her children that were approximately 20 times what would have been a reasonable fee, and the trustees made no effort to determine what would be a reasonable fee, the portion of the compensation that was excessive constituted a taxable gift from the income beneficiary to the trustee. If there is any question about the reasonableness of the trustee compensation, the trustee should document the efforts that were made to determine a reasonable level of compensation.

Because trustee fees are a deduction against the trust's gross income (see IRC §67(e)), and accordingly reduce the amount available for income distributions to the beneficiaries and taxable to them, the trust's tax year and the beneficiaries' years, if different, should be considered in determining when the trustee should take fees. Depending on the beneficiaries' tax circumstances, it may be more advantageous to spread out the fee payments rather than compress them all into one tax year.

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§9.31 F. Compensation Limitations When Attorney Is Trustee

For services rendered on or after January 1, 1994, by an attorney-trustee, Prob C §15687 places very specific limitations on the attorney's ability to obtain compensation both as counsel and as trustee. Prob C §15687(f). The section applies to all trusts, whether or not in existence on that date. Any waiver of the section's requirements is against public policy and is void. Prob C §15687(e). In general, a trustee who is an attorney may receive only the trustee's compensation or compensation for legal services performed for the trustee, unless the trustee obtains approval for the right to dual compensation as provided under Prob C §15687(d). Prob C §15687(a). The section does not apply if the trustee is related by blood or marriage to, or is a cohabitant with, the settlor. Prob C §15687(c).

The trustee may hire attorneys, even if they are associated or affiliated with the trustee, to advise or assist the trustee in the performance of administrative duties. Prob C §16247. However, no parent, child, sibling, or spouse of a person who is a trustee, and no law partnership or corporation whose partner, shareholder, or employee is serving as a trustee, shall receive any compensation for legal services performed for the trustee unless the trustee waives trustee compensation or unless the trustee obtains approval for the right to dual compensation as provided in Prob C §15687(d). Prob C §15687(b).

The trustee may obtain approval for dual compensation after full disclosure of the nature of the compensation and relationship of the trustee to all persons receiving compensation under Prob C §15687 by either (1) an order under Prob C §17200(b)(21) or (2) giving 30 days' advance written notice to the persons entitled to notice under Prob C §17203 of his or her intent to ask for compensation both as attorney and trustee. Prob C §15687(d). Within that 30-day period, any of the persons receiving notice may object to the action either by a written notice to the trustee or by filing a petition under Prob C §17200(b)(21). If an objection is received by the trustee within the 30-day period, then the trustee must file his or her own petition under Prob C §17200(b)(21) if he or she still wishes to receive the dual compensation. Prob C §15687(d)(2).

Because the statute contemplates that the beneficiaries will have a reasonable opportunity to object without having to file objections with the court, the notice should probably be sent at least annually, if not each time dual compensation is to be taken. It is not clear, however, how often the sending of the notice is actually required.

See §§9.57-9.60 for Petition and Order forms.

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§9.32 G. Effect of Breach of Trust on Compensation

One of the factors the court considers in determining reasonable compensation is the trustee's manifest "fidelity or disloyalty." Cal Rules of Ct 7.776; *Estate of McLaughlin* (1954) 43 C2d 462, 468, 274 P2d 868. Probate Code §16420(a)(7) provides that when a trustee is found to have breached the duty of loyalty, compensation may be reduced or denied. However, breach is only one of many factors the court must consider in determining whether compensation should be awarded and in what amount; it must look to the trustee's performance of other fiduciary duties relating to the trust as well as to all of the services performed. See §9.5. Accordingly, if the trustee has mismanaged only some of the assets in the trust estate, the court may deny compensation only for services rendered with respect to the mismanaged assets. *Estate of Gump* (1991) 1 CA4th 582, 2 CR2d 269; *Estate of Gump* (1982) 128 CA3d 111, 180 CR 219; *Estate of Cassity* (1980) 106 CA3d 569, 165 CR 88. See also *Estate of Bonaccorsi* (1999) 69 CA4th 462, 81 CR2d 604. For trustee and attorney fees in litigation arising out of a breach of trust, see §§9.49-9.54.

In *Nickel v Bank of America* (9th Cir 2002) 290 F3d 1134, the corporate trustee had, over a period of several years, overcharged approximately 2500 trusts with which it had entered into contractual fee arrangements. The trustee refunded the overcharged amounts, with simple interest, under the provisions of Prob C §§16440(a)(1) and 16441(a). The court held that the proper measure of damages under Prob C §16440(a)(2) was the amount of any profit made by the trustee through the breach of trust, with interest.

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§9.33 H. Resolving Compensation Disputes

If a beneficiary of an unsupervised trust (or the settlor of a revocable trust under Prob C §15800) objects to the compensation requested by the trustee and cannot resolve the dispute by compromise, the beneficiary or settlor can petition the court under Prob C §17200(b)(9) for judicial determination of whether the trustee's fees are justified. See §9.21. Even when the settlor or a beneficiary can remove a trustee whose fees are considered unreasonable, removal does not relieve the trust of the obligation to pay the trustee reasonable compensation for past services. See 4 Scott & Ascher on Trusts §21.1.10 (5th ed 2007).

A trustee involved in a dispute over compensation can also petition the court under Prob C §17200(b)(9). He or she can ask the court to approve compensation and, if the trustee has been removed, direct that a successor trustee pay it.

The beneficiary of a court-supervised trust may object to compensation at the hearing on the account in which the compensation is requested. See §9.22.

Because of the potential for compensation disputes, it is important that the trustee keep detailed records of all services rendered, including dates, the time spent on the matters, the complexity of the issues involved, the results achieved and the benefit to the trust.

PRACTICE TIP: In compensation disputes, the trustee's attorney can perform a vital role as mediator between the trustee and the beneficiaries or settlor. Quite often, the attorney knows all the parties personally and can explain to them why the trustee is entitled to the fees requested, or, conversely, can ask the trustee to consider a more reasonable amount. Because the trustee is the client, however, the attorney must defend the trustee against a challenge by the settlor or beneficiary when the dispute cannot be resolved.

For disputes over allocation of compensation among cotrustees, see §9.18.

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II. COMPENSATION OF ATTORNEYS AND OTHER PROFESSIONALS

A. Attorney Fees

§9.34 1. Compensation Provisions in Governing Instrument

Standard provisions in most governing instruments give the trustee authority to hire agents and experts, including attorneys, but they do not usually specify the amount of compensation to be paid. When the trust instrument limits the amount that may be paid to attorneys, the trustee lacks authority, without a court order, to pay attorney fees in excess of this amount. If the trustee believes the authorized amount is unreasonably low, it may petition the court under Prob C §17200(b)(6) for authority to pay reasonable attorney fees, citing changed circumstances under Prob C §15403. For dual compensation as both trustee and attorney, see §9.31.

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons) and that will have total assets of more than $20,000 after receipt of those funds—the trust instruments must require the compensation of the attorney for the trustee to be in just and reasonable amounts that must be fixed and allowed by the court. Cal Rules of Ct 7.903(a)(1), (c)(8), (d).

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§9.35 2. No Compensation Provisions in Governing Instrument

The trustee has the power under Prob C §16247 to hire attorneys, accountants, and other agents and has the power to pay reasonable compensation to the attorney as an agent of the trust under Prob C §16243. See *Estate of Nazro* (1971) 15 CA3d 218, 93 CR 116, in which the court held that the requested attorney fees were excessive. See also Prob C §15684(a), which entitles the trustee to repayment of expenditures properly incurred in the trust's administration. A trustee who desires the protection offered by court approval may also bring a petition under Prob C §17200(b)(6) (instructing the trustee) or Prob C §17200(b)(8) (granting powers to the trustee), requesting authority to hire and compensate counsel.

Many trustees hire an attorney only for specific legal problems as they arise. Others retain attorneys on a continuing basis to provide guidance to the trustee. In both situations, it is prudent, to prevent any future misunderstanding with the beneficiaries, for the trustee of an unsupervised trust to advise them of the reasons for the decision to hire or retain counsel and the estimated costs of doing so. For dual compensation as both trustee and attorney, see §9.31.

For court-supervised trusts, the court reserves to itself the authority to fix attorney fees. Fees are typically paid to attorneys for preparation of the report on the trustee's accounting and the petition for its settlement, as well as for legal services for specific issues as they arise. Courts in most counties have adopted either formal or informal guidelines for attorney fees. Local court rules often require a fee declaration describing the services performed, the time expended, the average hourly rate, the results accomplished, and the benefit to the trust. Absent unusual circumstances, local rules tend to set attorney compensation for preparing a report and petition at a percentage of the amount recommended by the guidelines for compensating the trustee. When the attorney's services include the use of a paralegal, some local court rules require that the paralegal's time and hourly rate be specified. See §9.17. Attorneys who are unfamiliar with a particular jurisdiction that does not have a written policy should contact local counsel or the county clerk's office to ascertain what basis for calculating attorney fees would be acceptable to the court.

NOTE: Applications for attorney fees in trust proceedings are not subject to the 60-day limitation of Cal Rules of Ct 3.1702. See *Holloway v Edwards* (1998) 68 CA4th 94, 80 CR2d 166.

The attorney for a public guardian or public administrator appointed as a trustee under Prob C §15660.5 is entitled to reasonable compensation ($1000 minimum). Prob C §15688(b). See §9.19.

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§9.36 3. Fees Specified in Engagement Letters

The attorney is required by law to have an engagement letter for new, noncorporate clients (see Bus & P C §6148); in addition, it is good practice to have an engagement letter with each trustee whom the attorney represents as counsel. For unsupervised trusts, the letter should specify the attorney's hourly rates and can also spell out to the trustee how often the attorney expects to be paid, and what the attorney considers legal services versus trustee services. For court-supervised trusts, the letter should specify which attorney fees are subject to court approval and which may need to be paid by the trustee individually. Some corporate trustees have written policies for the payment of legal services, including limitations on when attorneys can increase hourly rates; the amount of reimbursement allowable for certain costs advanced, such as fax and photocopy charges; and the need for prior approval before undertaking large research projects. Attorneys representing corporate fiduciaries should always ask, at the inception of the relationship, whether the client has such a written or unwritten policy in order to avoid later misunderstandings.

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§9.37 4. Ordinary and Extraordinary Fees

For unsupervised trusts that do not contain provisions governing attorney compensation, the distinction between ordinary and extraordinary fees is not particularly relevant; the only applicable guideline is the requirement in Prob C §16243 that any attorney fees paid by the trustee must be reasonable. For such trusts, neither the trust instrument nor court-published rules set compensation guidelines for "ordinary" services. There is, therefore, no need to separately identify extraordinary services. The attorney typically bills the trustee for services rendered at his or her usual billing rate. Nonetheless, the attorney should always provide the trustee with a detailed statement, together with the underlying facts, for the trust records, which will be helpful to the trustee if the beneficiaries should later question the charges.

For supervised trusts, on the other hand, court guidelines regarding attorney fees may apply to the performance of ordinary legal services, such as the preparation of court accountings and assistance rendered to the trustee to perform ordinary administrative duties. In most counties, for simplicity, requests for attorney fees that exceed the local guideline amount for court-supervised trusts are classified as "extraordinary" and require a detailed exposition of services rendered. Courts often require that any request for a fee that exceeds the guidelines set forth the time devoted to each service rendered and the hourly rate charged for that service. The attorney may present this detail in the accounting petition, file a declaration separately, or present testimony in open court.

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§9.38 5. Resolving Fee Disputes

When the trustee disputes the attorney's charges and they are unable to come to an agreement, the fee amount is left to the court's discretion. The trustee can structure the petition for settlement of accounts so that the attorney requests payment separately, clearly indicating that the trustee does not concur with the attorney's request. The attorney has no standing to file a separate petition requesting fees. *Estate of Howard* (1976) 58 CA3d 250, 129 CR 836. See also Prob C §17200(a) (only a trustee or beneficiary of a trust may petition the court regarding the trust's internal affairs). Therefore, if the client-trustee refuses to include the attorney's request for fees in the petition to settle accounts, the attorney might have to bring a civil suit against the trustee to recover them.

Business and Professions Code §§6200-6204.5 provide for arbitration of fee disputes between attorneys and clients. The rules are voluntary for clients (unless a client has agreed to arbitration in writing) and mandatory on attorneys. The arbitration decision is not binding and, following the decision, the parties may apply for a trial de novo. Bus & P C §6203(b).

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§9.39 6. Separate Counsel for Cotrustees

Each individual or corporate trustee of a single trust may retain a separate attorney for advice and counsel. As with cotrustee compensation, the court does not normally grant duplicate fees to multiple attorneys for court-supervised trusts. See §9.18. When separate counsel are retained, the attorneys should agree in advance who will perform which specific functions and how the total attorney fees will be allocated. Such an agreement can prevent later arguments and make matters simpler for the trustees, who need to know to whom to refer different legal matters.

If the attorneys cannot agree on a division, each attorney should provide the court with a detailed description of the respective service rendered, the need for that service, and the fee requested for performing it. In disputed cases, the trustee should not verify the relevant portion of the petition, but each attorney should verify his or her own request. See California Probate Workflow Manual Revised §19.13 (rev ed Cal CEB 1989) for a form of attorney's declaration for fees that can be adapted for this purpose.

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§9.40 7. Source of Payment of Attorney Fees

When the trustee has hired an attorney on a trust matter in which the trustee could potentially be held liable in its individual capacity, as opposed to its fiduciary capacity, the trustee may consider paying the attorney fees out of its own funds rather than the trust's funds. In *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317, the successor trustee objected to the predecessor trustee's accounting and settlement and sought documents pertaining to the predecessor trustee's administration of the trust. Among the documents sought by the successor trustee were privileged communications between the predecessor trustee and its attorney. The California Supreme Court held that privileged communications between a trustee and its attorney on matters of trust administration must be disclosed to a successor trustee on request. The court also stated in dicta that the trustee may be able to avoid disclosing to a successor trustee legal advice that is personal in nature by hiring a separate lawyer and paying for the advice out of its own funds. If it pays the attorney fees from the trust's funds, the trustee may be exposing itself to the risk that the beneficiaries will replace it with a successor trustee who will claim access to all of the confidential communications and will be willing to disclose it to the beneficiaries. See also *Eddy v Fields* (2004) 121 CA4th 1543, 18 CR3d 487 (without reaching apparent conflict posed by statutory work product privilege and client's right to his or her file, court held that if work product privilege was waived by attorney with respect to predecessor trustee, it was also waived as to successor trustee).

Note, however, that in a later case alleging trustee misconduct, the California Supreme Court held that the issue of whether the fees of the trustee's attorney are paid from the trust's funds or from the trustee's own funds "is but one indicium in determining the existence of an attorney-client relationship… and, thus, who holds the privilege." *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 213, 91 CR2d 716. Even in the *Wells Fargo Bank* decision, however, the court acknowledged that "[t]he better practice may be for a trustee to seek reimbursement after any litigation with beneficiaries concludes, initially retaining separate counsel with personal funds."

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B. Compensation of Professionals Other Than Attorneys

§9.41 1. Compensation Provisions in Governing Instrument

As with compensation of trustees and attorneys, compensation of other professionals is governed by the trust instrument, to the extent it addresses the issue. Many trust instruments empower the trustee to hire consultants or agents such as accountants, auditors, or investment advisors to advise or assist the trustee, and authorize the trustee to pay such professionals reasonable compensation. Trust instruments usually do not contain more specific compensation provisions, although some trusts provide that the trustee is to receive a reduced fee when professionals are used for services that the trustee would otherwise be expected to perform. For example, a trustee is usually expected to make most investment management decisions, and the fees charged by corporate trustees usually assume that the trustee is being compensated for that function. When the trustee hires an outside investment advisor, one may expect the trustee's fee to be correspondingly reduced.

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons) and that will have total assets of more than $20,000 after receipt of those funds—the trust instruments must require the compensation of the members of any advisory committee to be in just and reasonable amounts that must be fixed and allowed by the court. Cal Rules of Ct 7.903(a)(1), (c)(8).

Although fee arrangements with professionals other than attorneys are not governed by the same strict standards as fee arrangements with attorneys, the same underlying principles apply, and the trustee is well advised to enter into written engagement letters with accountants, investment advisors, and other professionals. The letter should set forth the manner in which the fee will be determined and the services that will be covered by the fee.

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§9.42 2. No Compensation Provisions in Governing Instrument

The trustee has the power under Prob C §16247 to hire attorneys, accountants, and other agents and has the power to pay reasonable compensation to such professionals as agents of the trust under Prob C §16243. See also Prob C §15684(a), which entitles the trustee to repayment of expenditures properly incurred in the trust's administration.

Without contrary provisions in the governing instrument of an unsupervised trust, a trustee may take a full fee even if agents or consultants are employed. However, a beneficiary might well object to this procedure and bring the matter to the court's attention on a petition under Prob C §17200(b)(9). The trustee should be prepared to document why a request for apparently duplicate fees is reasonable under the circumstances.

The court, on its own motion, often adjusts the fees paid to the trustee of a court-supervised trust who has used the services of an agent or consultant. Some local court rules provide that the trustee's compensation should be reduced by the amount paid to agents and consultants for performance of the trustee's basic responsibilities. The trustee's attorney should be sure that the court is advised of any unusual factors that make the employment of such professionals desirable without a reduction in the trustee's compensation. See *Estate of McLaughlin* (1954) 43 C2d 462, 274 P2d 868, in which the court found that as long as the fees to agents for services to the trust were reasonable, the court was justified in allowing them.

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C. Procedure for Compensating Attorneys and Other Professionals

§9.43 1. Fee Procedure for Unsupervised Trusts

The trustee of an unsupervised trust will normally pay fees of attorneys, accountants, and other professional advisors and consultants as they come due, preferably after the services have been rendered. The trustee can pay the professional fees directly out of the trust or can pay them from its own funds and then seek reimbursement from the trust, assuming the expenditure was properly incurred or benefited the trust. Prob C §15684. With respect to extraordinary or nonrecurring services, the trustee may want to notify the beneficiaries in advance of the need to hire the professional and the expected cost of the services.

If the trustee foresees beneficiary objections to a particular expenditure, the trustee may consider bringing a petition under Prob C §17200(b)(6), (8), or Prob C §6325, seeking advance approval for the expenditure. If an attorney or other professional is likely to bill the trust frequently, as in prolonged litigation, the trustee may seek a blanket order authorizing periodic payment of such fees. See also §9.21.

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§9.44 2. Fee Procedure for Court-Supervised Trusts

The trustee of a court-supervised trust must get court approval before paying attorneys, accountants, or other professionals who have rendered services to the trust, or reimbursing itself from the trust for professional fees paid out of its own funds. Payment or reimbursement of such fees is normally allowed on the settlement of each account, but the request may be made in a separate petition submitted specifically for the purpose. The request should describe in detail the services provided, including dates, should specify the reason for the work, the time spent, the hourly rate of each person whose time was charged to the matter, the results achieved, and the benefit to the trust. See also §9.22. For Petition and Order forms, see §§9.57-9.60.

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§9.45 D. Allocation of Compensation of Attorneys and Other Professionals to Principal and Income

The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) governs every trust existing on or after January 1, 2000, except as the trust instrument expressly provides to the contrary. Prob C §16339. As with trustee compensation, if the trust instrument specifies a method of allocation, the Act provides that the trustee shall pay compensation of professionals from the source specified in the trust instrument, even if the Act identifies a different source of payment. Prob C §16335(a)(1). If the trust instrument gives the trustee discretion to determine the source of payment, the trustee may exercise that discretion even if doing so produces a result different from that specified by the Act. Prob C §16335(a)(2). The Act does, however, require the trustee to exercise its discretion impartially, unless the trust instrument instructs the trustee to favor one or more beneficiaries. See §9.28.

If the trust instrument neither specifies the source of payment nor gives the trustee discretion in this regard, the source specified in the Act prevails. Prob C §16335(a)(3). The Act provides that compensation of persons providing investment advisory or custodial services is to be allocated one-half to income and one-half to principal, as are expenses for accountings, judicial proceedings, and other matters that involve both the income and remainder interests, except as otherwise ordered by the court. Prob C §§16370(a)-(b), 16371(a)(1).

The Act is not clear about what standards the court should apply in ordering an allocation different from that specified in the Act. When disbursement involves the income and remainder interests disproportionately, it would seem that the court has the authority to apportion the compensation equitably between them. See §9.28. All other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including expenses of a proceeding or other matter that concerns primarily the income interest, are allocated to income. Prob C §16370(c). Expenses of a proceeding that primarily concerns principal, including a proceeding to construe the trust or to protect the trust or its property, and disbursements related to environmental matters, are allocated to principal. Prob C §16371(a)(4), (7). In *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639, the court held that attorney fees and costs incurred in successfully defending an action for invasion of the trust should be paid entirely from trust principal because the action primarily concerned the trust principal.

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§9.45A E. Deductibility of Investment Advisory Fees

To be excepted from the 2-percent floor of IRC §67(a), the costs must be trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts (*i.e.,* by individual taxpayers). IRC §67(e). The U.S. Supreme Court has held that the trust's investment advisory fees are deductible only to the extent that they exceed the 2-percent floor. *Knight v Commissioner* (2008) 552 US 181, 169 L Ed 2d 652, 128 S Ct 782. Proposed regulations would provide that advice on investing for total return is not unique to trusts, and therefore is subject to the 2-percent floor. Prop Treas Reg §1.67-4. The proposed regulations would further provide that, if the trust pays a single fee for costs that are unique to trusts and also for costs that are not unique, the trust must identify the portion of the fee that represents unique costs. In other words, it may not "bundle" fees. For tax years beginning before January 1, 2008, however, the IRS has stated that nongrantor trusts need not determine the portion of a bundled fiduciary fee that is subject to the 2-percent floor, but rather may deduct the full amount of costs subject to the 2-percent floor that are bundled as part of the fee paid to the trustee. Notice 2008-32, 2008-11 Int Rev Bull 593.

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III. TRUSTEE COMPENSATION AND ATTORNEY FEES IN LITIGATION

§9.46 A. Trustee Sued or Suing in Fiduciary Capacity

In a suit brought against the trust, the trustee is named a party to the litigation and sued in his or her fiduciary capacity in much the same way an individual is sued. For example, a tenant may sue the trustee for injuries suffered on trust-owned property, or a business employed by the trust may sue the trustee for breach of contract. In such cases, the trustee has a duty to defend the trust. Prob C §16011.

Conversely, trustees may have cause to bring suit against third parties and they have the power to do so. Prob C §§850, 16249. Most litigation in which the trustee is the plaintiff relates to trust assets, *e.g.,* unlawful detainer actions, collection suits on notes, or shareholder actions.

Other matters can arise in which the trust itself may incur no benefit or detriment, but the trustee is still obliged to take legal action. Most typically these matters surface in connection with suits brought against a beneficiary that require the trustee to provide counsel with information about the trust, *e.g.,* when garnishment proceedings are brought against the trust.

Regardless of the outcome of the lawsuit, any costs and damages incurred should be paid from the trust itself and not from the trustee's personal resources, unless the court finds that the litigation was the result of the trustee's misconduct. *Estate of Miller* (1968) 259 CA2d 536, 548, 66 CR 756; *Estate of Griffith* (1950) 97 CA2d 651, 218 P2d 149.

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§9.47 1. Trustee Compensation in Unsuccessful Litigation Against Trustee

When third parties sue the trust, *i.e.,* sue the trustee in his or her fiduciary capacity, as opposed to suing the trustee individually, time spent by the trustee in defending the trust cannot be considered routine or ordinary. See §9.3. Accordingly, the trustee should be entitled to additional compensation for his or her time, even when the defense is unsuccessful. The court has discretion to grant such fees. Additionally, Prob C §15684(a) allows the trustee to be reimbursed for expenses properly incurred in administering the trust. See *Conservatorship of Lefkowitz* (1996) 50 CA4th 1310, 58 CR2d 299. On trustee fees in elder abuse actions, see §15.44A.

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§9.48 2. Attorney Fees and Other Expenses in Unsuccessful Litigation Against Trustee

Because the trustee is called on to prosecute or defend actions, attorney fees incurred by the trustee in connection with third party litigation are proper charges against the trust. See Prob C §15684. This is so even when the defense of the trust is unsuccessful. As the court held in *Estate of Baird* (1955) 135 CA2d 343, 347, 287 P2d 372, disapproved on other grounds in *Estate of Schloss* (1961) 56 C2d 248, 256, 14 CR 643 (quoting *Dingwell v Seymour* (1928) 91 CA 483, 513, 267 P 327), "[t]he underlying principle which guides the court in allowing costs and attorneys' fees incidental to litigation out of a trust estate is that such litigation is a benefit and a service to the trust." Of course, the court has discretion to grant such fees. See *Metzenbaum v Metzenbaum* (1953) 115 CA2d 395, 252 P2d 31.

A beneficiary who successfully asserts an interest in the trust over the objections of the trustee or other beneficiaries is entitled to recover attorney fees from the trust. *Wells Fargo Bank v Marshall* (1993) 20 CA4th 447, 24 CR2d 507. However, in *David v Hermann* (2005) 129 CA4th 672, 28 CR3d 622, the court held that attorney fees were not properly awarded to a plaintiff who successfully contested the validity of a trust. Further, in litigation over a revocable trust amendment that changed the allocation of beneficial interests, the court of appeal held that the attorney for the trustee was not entitled to compensation because the dispute was between competing trust beneficiaries and not a challenge to the trust itself, and the trust did not benefit from the litigation. *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742. If attorney fees are incurred to defend the trust or to benefit the trust as a whole, the fees may be paid from the trust. However, if attorney fees are incurred by the trustee to advance the interests of one beneficiary over another, courts have held that the trustee must bear the fees. *Estate of Duffill* (1922) 188 C 536, 206 P 42; *Terry v Conlan* (2005) 131 CA4th 1445, 33 CR3d 603.

In *Whittlesey,* the court also held that, in a prior action involving the same trust amendment and the same attorney, the attorney, then representing the beneficiary named in the amendment, was entitled to fees for successfully defending the amendment against a challenge brought by a previous successor trustee that was dismissed for lack of standing. "Such an award is equitable because, had the [second] litigation … never been initiated, the amended trust would have remained in effect, and an award of fees from the trust would have been, in effect, an award from … the prevailing beneficiary." 104 CA4th at 1231. In *Terry*, the court held that attorney fees incurred by the surviving spouse trustee in attempting to enforce a court-approved settlement of a trust contest were not payable from trust because the trustee was advancing her personal interest as beneficiary.

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§9.49 B. Relief Sought by Beneficiaries Against Trustee

The ultimate recourse of trust beneficiaries who believe the trustee has not acted in their best interests is to move against the trustee as an individual. The relief sought can be limited to forcing the trustee's removal (Prob C §17200(b)(10)), but most suits brought by beneficiaries against trustees additionally ask for monetary damages, which, if the beneficiaries prevail, take the form of a surcharge against the trustee.

It is important that the trustee and those undertaking his or her defense keep detailed records of the services rendered, time spent, and expenses incurred in the course of the litigation. While recordkeeping is important in all aspects of administration, it is imperative in trust litigation that records support the contention of the trustee and others that the trust should pay the disputed compensation and fees.

On matters where the trustee anticipates being sued in an individual rather than a fiduciary capacity, the trustee may want to consider paying the attorney fees out of his or her own funds rather than from the trust's funds in order to ensure that privileged communications with the trustee's attorneys remain protected from successor trustees who may be friendly to the beneficiaries. See *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317; §9.40.

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1. When Trustee Prevails or Partially Prevails

§9.50 a. Trustee Compensation in Litigation With Favorable Result

When the litigation's outcome favors the trustee to any extent, the trustee may petition the court to be compensated for the time and effort expended in defense. Prob C §§15684, 17200. Such compensation is of the extraordinary type insofar as it is earned apart from the reasonable compensation allowed for managing the trust. See §9.3. See, *e.g., Estate of Gump* (1991) 1 CA4th 582, 2 CR2d 269. See also *Estate of Beach* (1975) 15 C3d 623, 125 CR 570, for an analogous situation in which an executor was allowed compensation for the time and effort spent on litigation in which the executor prevailed.

The compensation may be adjusted, depending on the culpability of the trustee. In many cases, a trustee is found to have been in breach of the trust for only part of the complaint. In these cases, compensation and fees may be partially allowed. For example, if the trustee disproves the majority of a beneficiary's charges, the trustee is entitled to compensation and expenses for defending the unjust complaints. See *Estate of Gump, supra*; *Estate of Cassity* (1980) 106 CA3d 569, 165 CR 88. See also §9.32 on the effect of breach of trust on compensation.

Probate Code §17211(a) provides that, if a beneficiary contests the trustee's account without reasonable cause and in bad faith, the trustee's fees incurred as a result of the litigation may be charged against the contesting beneficiary's interest in the trust. See *Estate of Ivey* (1994) 22 CA4th 873, 28 CR2d 16.

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§9.51 b. Attorney Fees and Other Expenses in Litigation With Favorable Result

In addition to attorneys, the trustee may need to employ accountants, expert witnesses, and other professionals to assist in the defense. The attorney fees and other litigation expenses incurred by a trustee who successfully defends a suit brought by a beneficiary against the trustee as an individual should be payable from the trust. See Prob C §15684. See also *Estate of Beach* (1975) 15 C3d 623, 125 CR 570 (attorney fees held payable from the estate); *Rudnick v Rudnick* (Dec. 2, 2009, F056585) 2009 Cal App Lexis 1938 (attorney fees may be charged against share of beneficiary who brought suit in bad faith); *Conley v Waite* (1933) 134 CA 505, 25 P2d 496.

Probate Code §17211(a) provides that, if a beneficiary contests the trustee's account without reasonable cause and in bad faith, the trustee's attorney fees and other litigation expenses may be charged against the contesting beneficiary's interest in the trust. See also provisions concerning attorney fee awards in decedent estate account proceedings in Prob C §11003(a). In *Estate of Ivey* (1994) 22 CA4th 873, 28 CR2d 16, the court found that a beneficiary's objections to the trustee's accounting were frivolous and in bad faith, and ordered the attorney fees and expenses of both the trustee and the other beneficiaries charged to the income interest of the complaining beneficiary, rather than charged to the trust's general fund. See also *Conley v Waite, supra*. Note that the court in *Ivey* also imposed sanctions under CCP §128.5. The trustee also may be entitled to attorney fees and costs incurred in requesting those attorney fees and expenses. The Prob C §17211(a) provisions concerning awards of attorney fees in trust account proceedings are essentially identical to those applicable in guardianship and conservatorship account proceedings in Prob C §2622.5. In *Guardianship of K.S.* (2009) 177 CA4th 1525, 100 CR3d 78, the court held that a guardian who was entitled to attorney fees and costs incurred in defending the guardian's accounts was also entitled to attorney fees and costs incurred in seeking those attorney fees and costs.

A trustee who is entitled to partial compensation for a partially successful defense should likewise be entitled to partial payment of attorney fees and other expenses by the trust. In *Estate of Cassity* (1980) 106 CA3d 569, 165 CR 88, the trustee was entitled to charge to the trust a share of attorney fees proportionate to the degree to which the defense was successful. See also *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742, discussed in §9.48.

Almost all of the California trust cases in which contested litigation fees and compensation were in issue have been testamentary trusts under continuing court supervision. See, *e.g., Estate of Gump* (1982) 128 CA3d 111, 180 CR 219. There is no reason to assume, however, that the court would find differently regarding a trust not subject to continuing court supervision.

The trustee may be required to show that it subjectively believed that the expense for which reimbursement is sought was necessary or appropriate to carry out the purpose of the trust and that that belief was objectively reasonable. See *Conservatorship of Lefkowitz* (1996) 50 CA4th 1310, 58 CR2d 299, involving removal of a conservator.

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2. When Trustee Loses

§9.52 a. Trustee Compensation in Litigation With Unfavorable Result

The trustee against whom the beneficiary's charges are proved cannot claim compensation from the trust for the time spent in the litigation. *Estate of Vokal* (1953) 121 CA2d 252, 263 P2d 64. The trustee may nevertheless be entitled to compensation for routine or nonlitigated trust services adequately performed on the trust's behalf. *Estate of Gump* (1991) 1 CA4th 582, 2 CR2d 269; *Estate of Gump* (1982) 128 CA3d 111, 180 CR 219; *Estate of Gilmaker* (1964) 226 CA2d 658, 38 CR 270. When a surcharge is imposed against a trustee who is also a beneficiary, the court may impound that beneficiary's share of the trust estate to satisfy the surcharge. *Chatard v Oveross* (Nov. 30, 2009, B213392) 2009 Cal App Lexis 1908.

Probate Code §17211(b) provides that, if a beneficiary contests the trustee's account and the trustee opposes the contest without reasonable cause and in bad faith, the contestant's attorney fees and other litigation expenses may be charged against the trustee's compensation. See §9.54.

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§9.53 b. Attorney Fees and Other Expenses in Litigation With Unfavorable Result

The trustee is not entitled to reimbursement by the trust for attorney fees and other litigation expenses incurred in an unsuccessful litigation defense. See *Metzenbaum v Metzenbaum* (1953) 115 CA2d 395, 252 P2d 31. The fact that the trustee acted reasonably and in good faith in contesting allegations by a beneficiary is insufficient grounds for the trust to pay the attorney fees when the trustee loses. *Estate of Gilmaker* (1964) 226 CA2d 658, 38 CR 270. See also *Whittlesey v Aiello* (2002) 104 CA4th 1221, 1227, 128 CR2d 742, in which the court in dicta stated that litigation seeking to remove or surcharge a trustee for mismanagement of trust assets would not warrant the trustee to hire counsel at the trust's expense, because such litigation would be for the benefit of the trustee, not the trust. For discussion of the *Whittlesey* holding, see §9.48.

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§9.54 c. Compensation for Attorney Representing Beneficiary-Plaintiff

When the litigation brought by the beneficiary has resulted in a benefit to the trust itself, the fees for the beneficiary's attorney may be considered a proper charge against the trust. *Churchill v Peters* (1943) 57 CA2d 521, 134 P2d 841. Conversely, when the litigation does not result in a benefit to the trust, such fees may not be charged against the trust. *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639; *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742. See also *Copley v Copley* (1981) 126 CA3d 248, 178 CR 842, regarding application of the common fund doctrine, which provides that a beneficiary who incurs attorney fees that benefit the trust may require that those fees be paid by the trust. But see *Gray v Don Miller & Assocs.* (1984) 35 C3d 498, 198 CR 551, regarding the California Supreme Court's reluctance to depart from the rule that each party must pay its own attorney fees. See also *Estate of Gump* (1982) 128 CA3d 111, 180 CR 219, in which the court rejected application of the common fund doctrine and ordered the beneficiaries to pay their own attorney and accountant fees.

Probate Code §17211(b) provides that, if a beneficiary contests the trustee's account and the trustee opposes the contest without reasonable cause and in bad faith, the contestant's attorney fees and other litigation expenses may be charged against the trustee personally. See also Prob C §11003(b). See *Werschkull v United Cal. Bank* (1978) 85 CA3d 981, 149 CR 829, in which the court remanded the issue of fees because the award of attorney fees bore no relationship to the rate of compensation and the number of hours spent by the attorneys. 85 CA3d at 1007.

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§9.55 3. Attorney Fees and Other Expenses in Settlement Agreements

When potential or actual surcharge litigation is settled before a judicial decision is reached, the settlement agreement normally includes provisions for the payment of fees and expenses. These provisions are binding on all parties, notwithstanding any deviation from statute or case law. If the settlement provides for payment of any or all fees and expenses from the trust, the trustee and the trustee's attorney must be sure that the entire class of concerned beneficiaries is advised and consents to the settlement. To prevent the same matter from being litigated in the future by any of the class who are minor, unborn, unascertained, incompetent, or contingent beneficiaries, the trustee's attorney must be sure that they are validly represented and do consent to the settlement. Valid consents can be ensured by presenting the settlement agreement to the court and requesting that a guardian ad litem be appointed for minors and incapacitated persons under Prob C §1003, unless they are already represented by a court-appointed guardian or conservator.

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§9.56 4. Allocating Litigation Expenses to Principal and Income

The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) governs every trust existing on or after January 1, 2000, except as the trust instrument expressly provides to the contrary. Prob C §16339.

If the trust instrument specifies a source of payment, the Act provides that the trustee shall pay compensation of professionals from that source, even if the Act identifies a different source of payment. Prob C §16335(a)(1). If the trust instrument gives the trustee discretion to determine the source of payment, the trustee may exercise that discretion even if doing so produces a result different from that specified by the Act. Prob C §16335(a)(2). The Act does require, however, that the trustee exercise its discretion impartially, unless the trust instrument instructs the trustee to favor one or more beneficiaries. See Prob C §§16335(b), 16003. See also §9.28.

If the trust instrument neither specifies the source of payment nor gives the trustee discretion in this regard, the source specified in the Act prevails. Prob C §16335(a)(3). The Act provides that expenses involving both the income and remainder interests are to be allocated one-half to income and one-half to principal, except as otherwise ordered by the court. Prob C §§16370(a)-(b), 16371(a)(1). This would usually include litigation expenses. However, litigation expenses that primarily concern the income interest are allocated to income (Prob C §16370(c)) and litigation expenses that primarily concern principal are allocated to principal (Prob C §16371(a)(4), (7)). See §9.45.

When a beneficiary sues the trustee in bad faith, the attorney fees and expenses of the trustee and the other beneficiaries may be charged against the income interest of the complaining beneficiary, rather than against the trust's general fund. *Estate of Ivey* (1994) 22 CA4th 873, 28 CR2d 16. See Prob C §17211(a). See also §9.51.

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Source: Estate Planning/California Trust Administration/9 Trustee Compensation, Attorney Fees, and Other Administrative Costs/ IV. PETITION AND ORDER TO APPROVE COMPENSATION/§9.57 A. Form: Petition to Approve Trustee Compensation and Attorney Fees

IV. PETITION AND ORDER TO APPROVE COMPENSATION

§9.57 A. Form: Petition to Approve Trustee Compensation and Attorney Fees

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In the Matter of _ _[*name of trust*]_ _	**No.** _ _ _ _ _ _ **PETITION FOR ORDER APPROVING COMPENSATION OF TRUSTEE AND COMPENSATION OF ATTORNEYS TO TRUSTEE (PROB C §§16243, 16247, 17200(b)(9)** [*Add if dual compensation case*] _ _[*and 17200(b)(21)*]_ _**)** **Hearing Date:** _ _[*date*]_ _ **Time:** _ _[*time*]_ _ **Dep't:** _ _[*number*]_ _ **Judge:** _ _[*if known*]_ _

_ _[*Name of trustee*]_ _**, Trustee of the** _ _[*name of trust*]_ _ **(the "Trust"), dated** _ _[*date of trust*]_ _**, a copy of which is attached hereto as Exhibit "A," presents its verified Petition for Order Approving Compensation of Trustees and Compensation of Attorneys to Trustees, alleging as follows:**

1. This Court has jurisdiction to hear this petition and to grant the relief requested herein under Probate Code §17200 for the reason that this petition deals with the internal affairs of a trust.

2. The principal place of administration of the Trust is _ _[*name of county*]_ _**, California.**

3. _ _[*Briefly summarize terms of trust, e.g., The Trust provides that net income of the Trust is to be paid quarterly to* _ _[*name of beneficiary*]_ _ *for his life. On the death of* _ _[*name of beneficiary*]_ _*, the Trust is to terminate and be distributed to the issue of* _ _[*name of beneficiary*]_ _*, by right of representation.*]_ _

4. _ _[*Briefly summarize trustee succession history, e.g., The trust instrument names* _ _[*name of initial trustee*]_ _ *as Trustee of the Trust. By Order of this Court dated* _ _[*date*]_ _*,* _ _[*name of current trustee*]_ _ *was appointed to succeed* _ _[*name of initial trustee*]_ _ *as Trustee of the Trust. Since* _ _[*date*]_ _*,* _ _[*name of current trustee*]_ _ *has been and continues to be the duly appointed, qualified and acting Trustee of the Trust.*]_ _

5. The current value of the trust estate consisting of _ _[*summarize assets*]_ _ **is approximately $**_ _[*dollar amount*]_ _**. The annual income of the trust estate is approximately $**_ _[*dollar amount*]_ _**.**

6. _ _[*Summarize compensation provisions of trust, e.g., Paragraph ___ of the Trust provides that the Trustee shall be paid compensation equal to __% of the value of the trust assets per annum. OR Paragraph ___ of the Trust provides that the Trustee shall be paid reasonable compensation.*]_ _

[*Add one of the following alternatives*]

[*Alternative 1*]

7. Request for Compensation Provided in Trust Instrument. Throughout the period covered by this petition,

_ _[*date*]_ _ to _ _[*date*]_ _, inclusive, _ _[*name of trustee*]_ _ has performed the customary duties of a trustee, including management of investments, collection and distribution of income, preparation of tax returns, and preparation of court accountings. In view of the time expended, the responsibility assumed, and the results achieved, Petitioner believes that compensation as provided in the trust instrument is appropriate. Petitioner therefore requests that ordinary compensation for _ _[*name of trustee*]_ _ be approved equal to __% of the trust value, or $_ _[*dollar amount*]_ _.

[*Alternative 2*]

7. Request for Ordinary Compensation of Trustee. Throughout the period covered by this petition, _ _[*date*]_ _ to _ _[*date*]_ _, inclusive,_ _[*name of trustee*]_ _ has performed the customary duties of a trustee, including management of investments, collection and distribution of income, preparation of tax returns, and preparation of court accountings. In view of the time expended, the responsibility assumed, and the results achieved, Petitioner is informed and believes that a fee equal to __% of the value of the trust assets for a trust of this size and nature is reasonable and customary in this community. Petitioner therefore requests that ordinary compensation for _ _[*name of trustee*]_ _ be approved equal to __% of the trust value per annum, or $_ _[*dollar amount*]_ _.

[*Continue*]

[*If appropriate, add*]

8. Request for Extraordinary Compensation of Trustee. During the period covered by this petition, _ _[*date*]_ _ to _ _[*date*]_ _, in addition to performing the customary duties of a trustee, _ _[*name of trustee*]_ _ has also performed extraordinary duties as follows: _ _[*List extraordinary duties, e.g., renovation or sale of principal residence, management of family business, etc.*]_ _. Specifically, _ _[*name of trustee*]_ _ has _ _[*performed the following functions: _ _[List functions*]_ _/performed the functions described in the Fee Declaration attached as Exhibit A*]_ _. The Trustee has devoted approximately __ hours to the performance of the foregoing responsibilities. In view of the time expended, the responsibility assumed, the results achieved, and the size of the trust estate, Petitioner is informed and believes that an average hourly rate of $_ _[*dollar amount*]_ _ for the performance of such responsibilities is reasonable and customary in this community. Petitioner therefore requests that extraordinary compensation be approved for _ _[*name of trustee*]_ _ in the amount of $_ _[*dollar amount*]_ _.

[*Continue*]

[9.] Request for Reimbursement of Trustee's Out-of-Pocket Expenses. In addition, _ _[*name of trustee*]_ _ has incurred out-of-pocket expenses of $_ _[*dollar amount*]_ _, consisting of $_ _[*dollar amount*]_ _ of telephone calls, $_ _[*dollar amount*]_ _ of photocopying expenses, and $_ _[*dollar amount*]_ _ of travel expenses. Petitioner is informed and believes that such expenses are reasonable and requests Court approval for reimbursement of such amounts.

[10.] Request for Authorization to Pay Trustee's Attorneys. During the period covered by this petition, Petitioner retained the services of _ _[*name of attorneys*]_ _ to provide _ _[*list legal services provided, e.g., tax advice in connection with powers of appointment, preparation of petition for modification of trust, etc.*]_ _. The services provided by _ _[*name of attorneys*]_ _ in connection with the foregoing matters are more fully described and itemized in the Fee Declaration of _ _[*name of attorneys*]_ _, attached as Exhibit B hereto and incorporated herein by reference. _ _[*Name of attorneys*]_ _ expended ___ hours in connection with the foregoing matters. _ _[*Name of attorneys*]_ _'s fees for such services amount to $_ _[*dollar amount*]_ _, which represents an average hourly rate of $_ _[*dollar amount*]_ _. _ _[*Name of attorneys*]_ _'s out-of-pocket costs, consisting of $_ _[*dollar amount*]_ _ of telephone calls and $_ _[*dollar amount*]_ _ of photocopying expenses, totaled $_ _[*dollar amount*]_ _, for a combined total of $_ _[*dollar amount*]_ _. Petitioner is informed and believes that such fees and costs are reasonable and customary in this community and requests Court approval for payment to _ _[*name of attorneys*]_ _ of such amounts.

[*Add one of the following alternatives*]

[*Alternative 1*]

[11.] Petitioner is neither a partner, shareholder, or employee of _ _[*name of attorneys*]_ _. No parent, child, sibling, or spouse of Petitioner is a partner, shareholder, or employee of _ _[*name of attorneys*]_ _.

[*Alternative 2*]

[11.] Dual Compensation. Petitioner, _ _[*name of trustee*]_ _, is a partner of _ _[*name of attorneys*]_ _. Petitioner has given the notice of request for dual compensation required under Probate Code §15687(d), a copy of which is attached hereto as Exhibit C. More than 30 days have elapsed since the mailing of such notice, and Petitioner has received no objection to the proposed action.

[*Continue*]

[12.] The names and addresses of all interested persons, so far as known by Petitioner, are as follows: _ _[*names, ages, and addresses of beneficiaries*]_ _**.**

[*Add one of the following alternatives*]

[*Alternative 1*]

[13.] No requests for special notice have been filed in this case.

[*Alternative 2*]

[13.] The following have filed requests for special notice in this case: _ _[*List names and addresses*]_ _**.**

[*Continue*]

WHEREFORE, Petitioner prays:

1. That this petition be set for hearing and that notice thereof be given in the manner required by law;

2. That the Court find that it has jurisdiction to grant the relief requested in this petition under Probate Code §17200;

3. That the Court approve and direct the payment of ordinary fees to _ _[*name of trustee*]_ _ **of $**_ _[*dollar amount*]_ _**; payment of extraordinary fees to** _ _[*name of trustee*]_ _ **of $**_ _[*dollar amount*]_ _**; and reimbursement to** _ _[*name of trustee*]_ _ **of** _ _[*his/her/its*]_ _ **out-of-pocket expenses of $**_ _[*dollar amount*]_ _**.**

4. That the Court approve and direct the payment of $_ _[*dollar amount*]_ _ **to** _ _[*name of attorneys*]_ _**, for its legal services rendered to Petitioner and reimbursement to** _ _[*name of attorneys*]_ _ **of** _ _[*his/her/its*]_ _ **out-of-pocket expenses of $**_ _[*dollar amount*]_ _**.**

5. For such other and further relief as the Court may deem appropriate.

[*Add one of the following alternatives*]

[*Alternative 1*]

Date: _ _ _ _ _ _

_ _[*Name of institutional trustee*]_ _**,**
Trustee

_ _[*Signature*]_ _
By: __[*Name of Officer*]__
Title: _ _[*Title of Officer*]_ _

[*Alternative 2*]

Date: _ _ _ _ _ _

_ _[*Name of individual trustee*]_ _**,**
Trustee

_ _[*Name of attorneys*]_ _

By: _____
Attorneys for Petitioner

VERIFICATION

I have read the foregoing Petition for Order Approving Compensation of Trustee and Compensation of

Attorneys to Trustee and know its contents. I am a party to this action. The matters stated in it are true of my own knowledge except as to those matters which are stated on information and belief, and as to those matters I believe them to be true. I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

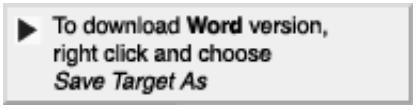
Executed on _ _[*date*]**_ _, at _ _**[*city*]**_ _ , California.**

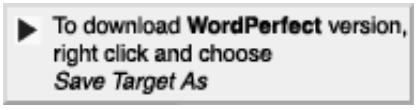
__[*Signature of trustee*]__

Comment: If there are cotrustees, one of the two alternatives in §9.58 may be inserted after paragraph 9. The form should then be modified wherever appropriate to indicate that there are cotrustees and the subsequent paragraphs renumbered.

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§9.58 B. Form: Additional Petition Clauses for Cotrustees





[*Add one of the following alternatives*]

[*Alternative 1: Waiver of fees*]

[10.] Waiver of Fees of Individual Cotrustee. Since _ _[*his/her/its*]**_ _ appointment as Cotrustee of the Trust, _ _**[*name of cotrustee*]**_ _ has waived and continues to waive _ _**[*his/her/its*]**_ _ right to receive compensation for _ _**[*his/her/its*]**_ _ services as Cotrustee of the Trust.**

[*Alternative 2: Request for compensation*]

[10.] In addition to the compensation requested for _ _[*name of trustee*]**_ _, Petitioner requests compensation for _ _**[*name of cotrustee*]**_ _ for _ _**[*his/her/its*]**_ _ time and efforts spent reviewing trust investments, tax returns, court accountings, and other documentation relating to the Trust. _ _**[*Name of cotrustee*]**_ _ expended ___ hours in connection with the foregoing matters. Petitioner is informed and believes that an hourly rate of $_ _**[*dollar amount*]**_ _ for such services is reasonable and customary in this community and therefore requests that compensation be approved for _ _**[*name of cotrustee*]**_ _ equal to $_ _**[*dollar amount*]**_ _.**

Comment: If there are cotrustees, one of the two alternatives above may be inserted after paragraph 9 in the form in §9.57. The form in §9.57 should then be modified wherever appropriate to indicate that there are cotrustees and the subsequent paragraphs renumbered. All cotrustees should sign the petition.

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§9.59 C. Form: Order Approving Trustee Compensation and Attorney Fees

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In the Matter of
_ _[*name of trust*]_ _

No. _ _ _ _ _ _
ORDER APPROVING COMPENSATION OF TRUSTEE AND COMPENSATION OF ATTORNEYS TO TRUSTEE
Hearing Date:
Time:
Dept:

_ _[*Name of trustee*]_ _**, Trustee of the** _ _[*name of trust*]_ _ **(the "Trust"), dated** _ _[*date of trust*]_ _**, duly presented to this Court on** _ _[*date*]_ _**, the Honorable** _ _[*name of judge*]_ _ **presiding, its verified Petition for Order Approving Compensation of Trustee and Compensation of Attorneys to Trustee (the "petition").** _ _[*Name of attorney*]_ _ **appeared for the Petitioner.**

Having considered the petition and heard the evidence, the Court finds:

1. All notices of hearing have been given as required by law.

2. This Court has jurisdiction to grant the relief requested in the petition under Probate Code §§16243, 16247, 17200(b)(9)_ _[*and 17200(b)(21)*]_ _**.**

3. All of the allegations made in the petition are true.

[*Add one of the following alternatives*]

[*Alternative 1*]

4. Throughout the period covered by this petition, _ _[*date*]_ _ *to* _ _[*date*]_ _**,** _ _[*name of trustee*]_ _ **has performed the customary duties of a trustee, including management of investments, collection and distribution of income, preparation of tax returns, and preparation of court accountings. In view of the time expended, the responsibility assumed, and the results achieved, compensation as provided in the trust instrument, being equal to __% of the trust value, or $**_ _[*dollar amount*]_ _**, is reasonable.**

[*Alternative 2*]

4. Throughout the period _ _[*covered by this petition*]_ _**,** _ _[*name of trustee*]_ _ **has performed the customary duties of a trustee, including management of investments, collection and distribution of income, preparation of tax returns, and preparation of court accountings. Ordinary compensation for** _ _[*name of trustee*]_ _ **equal to __% of the trust value per annum, or $**_ _[*dollar amount*]_ _**, is reasonable.**

[*Continue*]

[*If appropriate, add*]

5. During the period _ _[*covered by this petition*]_ _**, in addition to performing the customary duties of a trustee,** _ _[*name of trustee*]_ _ **has devoted approximately __ hours to the performance of extraordinary responsibilities. An average hourly rate of $**_ _[*dollar amount*]_ _ **for the performance of such responsibilities, resulting in extraordinary compensation for** _ _[*name of trustee*]_ _ **equal to $**_ _[*dollar amount*]_ _**, is reasonable.**

[*Continue*]

[6.]_ _[*Name of trustee*]_ _ has incurred out-of-pocket expenses of $_ _[*dollar amount*]_ _, consisting of $_ _[*dollar amount*]_ _ of telephone calls, $_ _[*dollar amount*]_ _ of photocopying expenses, and $_ _[*dollar amount*]_ _ of travel expenses, and such expenses are reasonable.

[7.]_ _[*Name of attorneys*]_ _ expended ___ hours in connection with _ _[*list legal services provided*]_ _. _ _[*Name of attorneys*]_ _'s fees for such services amounting to $_ _[*dollar amount*]_ _, representing an average hourly rate of $_ _[*dollar amount*]_ _, and out-of-pocket costs totaling $_ _[*dollar amount*]_ _, are reasonable.

[*Add one of the following alternatives*]

[*Alternative 1*]

[8.] Petitioner is neither a partner, shareholder or employee of _ _[*name of attorneys*]_ _. No parent, child, sibling, or spouse of Petitioner is a partner, shareholder, or employee of _ _[*name of attorneys*]_ _.

[*Alternative 2*]

[8.] Petitioner, _ _[*name of trustee*]_ _, is a partner of _ _[*name of attorneys*]_ _. Petitioner has given the notice of request for dual compensation required under Probate Code §15687(d). More than 30 days have elapsed since the mailing of such notice, and Petitioner has received no objection to the proposed action.

[*Continue*]

Good cause appearing, therefore, the Court grants the petition as follows:

IT IS ORDERED, ADJUDGED, AND DECREED:

1. That notice of hearing has been given as required by law;

2. That payment of ordinary fees to _ _[*name of trustee*]_ _ of $_ _[*dollar amount*]_ _ is hereby approved and directed;

[*If appropriate, add*]

3. That payment of extraordinary fees to _ _[*name of trustee*]_ _ of $_ _[*dollar amount*]_ _ is hereby approved and directed;

[*Continue*]

[4.] That reimbursement to _ _[*name of trustee*]_ _ of its out-of-pocket expenses of $_ _[*dollar amount*]_ _ is hereby approved and directed;

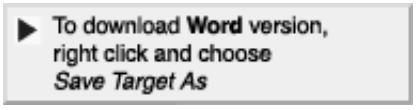
[5.] That payment of $_ _[*dollar amount*]_ _ to _ _[*name of attorneys*]_ _, for its legal services rendered to Petitioner and reimbursement to _ _[*name of attorneys*]_ _ of its out-of-pocket expenses of $_ _[*dollar amount*]_ _ are hereby approved and directed.

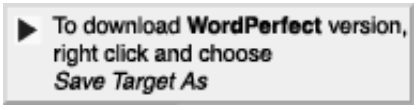
Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the _ _[*Superior Court*]_ _

Comment: If there are cotrustees, one of the two alternatives in §9.60 may be inserted after paragraph 9. The form should then be modified wherever appropriate to indicate that there are cotrustees and the subsequent paragraphs renumbered.

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§9.60 D. Form: Additional Order Clauses for Cotrustees





[*Add one of the following alternatives*]

[*Alternative 1: Waiver of fees*]

[7.]_ _[*Waiver of Fees of Individual Cotrustee*]_ _**. Since** _ _[*his/her/its*]_ _ **appointment as Cotrustee of the Trust,** _ _[*name of cotrustee*]_ _ **has waived and continues to waive** _ _[*his/her/its*]_ _ **right to receive compensation for** _ _[*his/her/its*]_ _ **services as Cotrustee of the Trust.**

[*Alternative 2: Request for compensation*]

[7.]_ _[*Name of cotrustee*]_ _ **has expended ___ hours reviewing trust investments, tax returns, court accountings, and other documentation relating to the Trust. An hourly rate of $**_ _[*dollar amount*]_ _ **for such services, resulting in compensation for** _ _[*name of cotrustee*]_ _ **equal to $**_ _[*dollar amount*]_ _**, is reasonable.**

Comment: If there are cotrustees, one of the two alternatives above may be inserted after paragraph 6 in the form in §9.59. The form in §9.59 should then be modified wherever appropriate to indicate that there are cotrustees and the subsequent paragraphs renumbered.

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10

Creditors' Rights Against the Trust

Michael Patiky Miller
Margaret M. Hand

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§10.1 I. SCOPE OF CHAPTER

This chapter focuses on creditors' rights against the trust assets *after* the settlor's death. Rules applicable to potential creditor claims *before* the settlor's death are briefly discussed in §§10.2-10.3.

After the settlor's death, the assets of the formerly revocable trust are subject to creditors' claims to the extent that the settlor's probate estate is inadequate, as will often be the case in the typical revocable trust context. See §§10.4-10.6. Assuming no probate administration has been opened, the trustee has the option of using the trust claims procedure in Prob C §§19000-19403, which is discussed in detail in §§10.26-10.63. If the trust claims procedure is not used, creditors may have to look to the distributees of the trust (see §10.7) or use alternative procedures such as a petition to appoint a personal representative (see §10.12) or a petition under Prob C §850 (see §10.13) to force the opening of a judicial proceeding. Creditors may not enforce a money judgment against trust assets but must be paid "in the course of administration." See §§10.8-10.9.

In deciding whether to initiate the trust claims procedure or to rely instead on the 1-year limitations period in CCP §366.2, the trustee should consider the extent to which constitutional due process issues may require actual notice of the trust administration to reasonably ascertainable creditors. See §§10.10-10.17. Claims of public creditors and notice requirements for public entities that a trustee must follow are discussed in §§10.18-10.25.

Creditors' rights against a trust beneficiary's interest are discussed in chap 10A.

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II. LIABILITY OF TRUST BEFORE SETTLOR'S DEATH

§10.2 1. To Extent of Settlor's Power to Revoke

The assets of a revocable trust are subject to the claims of the settlor's creditors to the extent of the settlor's power to revoke. Prob C §18200. In effect, this provision permits the creditor to "ignore the trust to the extent that it is revocable." Comment to Prob C §18200. Any settlor whose trust property is subject to creditors' claims under Prob C §18200 is entitled to all exemptions from enforcement of a money judgment under CCP §§703.010-704.995. Prob C §18201. For example, private retirement plan assets transferred to an individual retirement account (IRA) naming the participant's revocable trust as the designated beneficiary will continue to be completely exempt from the claims of the settlor's judgment creditors under CCP §704.115(d). See *McMullen v Haycock* (2007) 147 CA4th 753, 54 CR3d 660.

Unless a trust is expressly made irrevocable by the trust instrument, the trust is presumed revocable if (Prob C §15400):

- The settlor is domiciled in California when the trust is created;
- The trust instrument is executed in California; or
- The trust instrument provides that California law governs the trust.

In *Laycock v Hammer* (2006) 141 CA4th 25, 44 CR3d 921, the court held that evidence that the settlor indirectly borrowed money from a life insurance policy that was transferred to an irrevocable life insurance trust (ILIT) was insufficient to show that the trust was revocable and therefore subject to the claims of the settlor's creditors.

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§10.3 2. Restraint on Transfer of Self-Settled Trust Invalid

If a settlor is a beneficiary of a trust, any restraint on the transfer of his or her interest in the trust (*e.g.,* in the form of a spendthrift clause) is invalid against his or her transferees or creditors if the trust becomes irrevocable during the settlor's lifetime. Prob C §15304(a). If the trust directs the trustee to pay for the settlor's education and support or gives the trustee discretion over payments to the settlor, the creditor can reach all the assets that could be used by the trustee under the terms of the trust up to the amount of the settlor's proportionate contribution to the trust. Prob C §15304(b).

NOTE: "Settlor" includes not only the person who transfers property to the trustee, but any person who furnishes the consideration for the creation of a trust. Therefore, persons other than the transferor may be treated as the settlor of a trust. *McColgan v Walter Magee, Inc.* (1916) 172 C 182, 155 P 995; *Parscal v Parscal* (1983) 148 CA3d 1098, 1104, 196 CR 462. For this reason, a beneficiary arguably may become the settlor with respect to a portion of a trust to the extent that the trust gives the beneficiary a withdrawal power that the beneficiary fails to exercise. If an obligor funds a trust for the benefit of, and in satisfaction of his or her obligation to, his or her obligee, the latter is treated as the settlor of the trust. No restraint on alienation of the obligee's rights under the trust would be effective against a creditor of the obligee.

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III. LIABILITY OF REVOCABLE TRUST AFTER SETTLOR'S DEATH

§10.4 A. When Probate Estate Inadequate

If the trust was revocable by the deceased settlor at the time of death, such trust assets are subject to the claims of the creditors of the deceased settlor's estate to the extent that the probate estate is inadequate to satisfy those claims and the administration expenses of the estate. Prob C §19001(a).

Under Prob C §§19000-19403, trustees of funded living trusts may elect to use the probate court to process creditors' claims. The use of the claims procedure is *optional*, however, and the trustee incurs no liability by electing not to follow the procedure. Prob C §19010.

NOTE: Regardless of whether the trustee uses the optional trust claims procedure, a creditor may request and receive special notice of specified trust proceedings under Prob C §17200, including a proceeding initiated by the trustee to determine the liability of the trust for the settlor's debts (Prob C §17200(b)(20)). Prob C §17204(b)-(c). This right to receive notice, however, does not confer standing on the creditor that would not otherwise exist. Prob C §17204(b)(4). It may, however, inform the creditor of other creditors' pending actions against the trustee.

If the trustee does not use the procedures, and no probate proceeding is opened, the beneficiaries of the trust are generally liable for a prorata portion of creditors' claims, based on the amount of property received from the trust. Prob C §§19008, 19400. See §10.7.

When either the trust claims procedure is used or a probate proceeding is opened (see §10.5), approved claims can be paid from trust assets retained by the trustee (see §10.6) only in the course of administration (see §10.8) pursuant to a final judgment (see §10.9) against the trustee or the estate administrator rendered in the course of the proceeding.

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§10.5 1. Claims Processed in Probate Proceeding

If a probate proceeding is opened, either by the personal representative or by a creditor (see §10.12) or beneficiary as an interested person (see Prob C §48), creditor claims must be processed in accordance with Prob C §§9000-9399. See 2 California Decedent Estate Practice, chap 14 (2d ed Cal CEB 2009). The trustee is barred from initiating the trust claims procedure when the trustee has actual knowledge that a petition for probate or intestate administration has been filed. Prob C §19003(a). The trust estate and the beneficiaries are protected from untimely filed claims in the probate proceeding. Prob C §§9351, 19006(b). The probate estate must be exhausted by costs of administration and claims with higher priority before the trust estate is liable. *Dobler v Arluk Med. Ctr. Indus. Group, Inc.* (2001) 89 CA4th 530, 107 CR2d 478 (*Dobler I*). However, *Dobler I* left open the question of whether the trustee has an obligation to retain trust assets for the benefit of creditors when the probate estate is inadequate; that question was decided in *Arluk Med. Ctr. Indus. Group, Inc. v Dobler* (2004) 116 CA4th 1324, 11 CR3d 194 (*Dobler II*). See §10.6.

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§10.6 2. Trustee's Obligation to Retain Trust Assets When Probate Estate Inadequate

In *Dobler v Arluk Med. Ctr. Indus. Group, Inc.* (2001) 89 CA4th 530, 107 CR2d 478 (*Dobler I*), the court implied in dictum that the trustee may have a duty to take steps to discover whether probate proceedings had opened, and if so, to retain trust assets sufficient to pay disputed debts that exceed the value of the assets in the probate estate. 89 CA4th at 542.

However, in *Arluk Med. Ctr. Indus. Group, Inc. v Dobler* (2004) 116 CA4th 1324, 11 CR3d 194 (*Dobler II*), the court of appeal held that the trustees of the deceased settlor's revocable trust had no duty to refrain from making trust distributions pending resolution of a disputed creditor's claim filed in the settlor's probate estate proceeding. Even though the trustees in *Dobler I* and *II* were also executors of the decedent's estate and thus had actual knowledge of the disputed debt, they could not be surcharged for making distributions to trust beneficiaries during the pendency of the litigation in the decedent's estate. *Dobler II* establishes that trustees have no duty to preserve trust assets for the benefit of a potentially successful judgment creditor against the decedent's estate. The pendency of probate proceedings did not alter the trustees' statutory duty to administer the trust solely for the benefit of trust beneficiaries. 116 CA4th at 1337.

Dobler II held that, to the extent beneficiaries receive any distributions, the successful judgment creditors can pursue the distributees under Prob C §19400 as though there had been no probate and no formal claims proceedings. 116 CA4th at 1338. Such a remedy may be illusory, however, if the beneficiaries are located outside of California or have dissipated their inheritances before the judgment creditors realize that the estate and trust are unable to satisfy their judgment. Thus, creditors of decedents who leave well-funded revocable trusts are at a disadvantage. Unlike the creditors of one whose estate must be probated, these creditors may prove their right to payment by obtaining a judgment against the decedent's personal representative but may be unable to collect on that judgment because the assets have been distributed by the trustee.

When litigation is brought on a rejected claim in the optional trust claims procedure, a notice of pendency of the action or referral to a referee or arbitrator must be filed in the trust proceeding, together with proof of service of the notice to the trustee. Prob C §19255(c). See §§10.59-10.60. There is still no procedure to file a notice of pendency of litigation in a trust when the litigation must proceed against the probate estate because a probate proceeding has been opened (and a probate proceeding trumps a trust claims action). *Dobler II*, in the author's opinion, is an invitation for trustees to ignore creditors with impunity if a formal probate is opened and, as a result, claims have to be litigated against what might be a "shell" of overall assets. The trustee may, however, have a duty to keep the beneficiaries informed of pending litigation. See §10.7.

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§10.7 B. Distributee Liability When No Probate Administration and No Trust Claims Procedure (Prob C §19400)

If no probate administration and no trust claims procedure are initiated, then a trust beneficiary to whom payment, delivery, or transfer of the deceased settlor's property is made under the terms of the trust is personally liable for the unsecured claims of the creditors of the deceased settlor's estate. Prob C §19400. Suit must be filed within 1 year of the date of the deceased settlor's death unless the limitations period is tolled or extended. CCP §366.2; Prob C §19400. See §§10.11-10.14 (particularly §10.14 on the issue of whether due process requires some form of actual notice). A 1-year limitations period also applies to claims based on the deceased settlor's promise or agreement to benefit a third party. CCP §366.3. See §10.17.

If the trust has been partially but not completely distributed, the beneficiary's personal liability is limited to (1) amounts that cannot be satisfied from the as yet undistributed trust estate and (2) a prorata portion of the creditor's claim, based on the amount of the beneficiary's distribution and the total trust distributions, not to exceed the amount received by the beneficiary. The creditor should commence a regular civil suit alleging the transferee's personal liability under the applicable statute. Any defenses that would have been available to the deceased settlor may be raised by his or her successor in interest. Prob C §19402.

PRACTICE TIP: Personal liability of beneficiaries can be a significant issue under the doctrine enunciated in *Arluk Med. Ctr. Indus. Group, Inc. v Dobler* (2004) 116 CA4th 1324, 11 CR3d 194 (*Dobler II*). See §10.6. If the trustee makes a distribution while a creditor's claim is pending in the deceased settlor's formal probate proceeding, a beneficiary would be well advised to hold onto the distribution in a safe form of investment, and the trustee in turn would be well advised to alert the beneficiary to the pending claim. The trustee is supposed to keep the beneficiaries reasonably informed of material matters regarding the trust and its administration, and keeping news of a pending litigation from the beneficiaries could be interpreted as a violation of that duty and thus a breach of trust. See Prob C §§16060, 16400. See also California Trust and Probate Litigation, chap 21 (Cal CEB 1999).

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§10.8 C. Payment of Approved Claims and Judgments

If a judgment is rendered or otherwise stipulated to, the creditor cannot execute against assets of either the probate estate or the trust estate. The judgment creditor is entitled to be paid "in the course of administration" under Prob C §§19300-19304 according to the order of priority for payment of claims set forth in Prob C §11420. Prob C §§19001(b), 19300.

An allowed claim has the same status as a final judgment. The law does not permit a creditor with a judgment to take precedence over creditors with approved claims. See Prob C §11420(a)(7). Conversely, a creditor with a final judgment does not also need an approved claim to be paid in the course of administration. In *Estate of Prindle* (2009) 173 CA4th 119, 92 CR3d 504, the court held that a decedent's liability insurer that refused to defend the administrator of the decedent's estate was estopped from claiming that a personal injury plaintiff's negligence suit was barred by the plaintiff's failure to first file a creditor's claim, because the plaintiff's civil judgment against the administrator was already final. See also *Dobler v Arluk Med. Ctr. Indus. Group, Inc.* (2001) 89 CA4th 530, 107 CR2d 478 (*Dobler I*) (creditor who filed a timely claim and action against the probate estate and in whose favor a judgment was rendered is not precluded, by virtue of its failure to file a separate claim against the trust, from seeking to satisfy its judgment out of trust assets when the probate estate is inadequate to satisfy the judgment).

NOTE: If the trust claims procedure is used and an action is brought on rejection of a claim, distributed property is not subject to the claim if the trustee distributed the property under the terms of the trust more than 120 days from the later of the time the notice of rejection of the claim is given or the claim is due, and before notice of pendency of action or referral or arbitration is filed and given, excluding any time during which there is a vacancy in the office of trustee. Neither the trustee nor the distributee is liable on account of the distribution. Prob C §19255(d). See §10.59.

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§10.9 D. Finality of Judgments Against Trust Assets

If the trust claims procedure is used, when a money judgment on a claim becomes final against a trustee in the trustee's representative capacity, it conclusively establishes the validity of the claim for the amount of the judgment. The judgment must provide that it is payable out of the property in the deceased settlor's trust estate in the course of administration. Prob C §19301. For these purposes, a final judgment against the trustee in the trustee's representative capacity may include a judgment against the decedent or against the estate administrator that is amended to add the trustee as a defendant.

In *Bank One Texas v Pollack* (1994) 24 CA4th 973, 29 CR2d 510, a judgment creditor sought to collect on a judgment entered against the deceased judgment debtor during his lifetime. The trial court entered an order granting the judgment creditor's motion to amend the judgment by naming as an additional defendant the trustee of the living trust established by the debtor, and the court of appeal held that it should also have entered the amended judgment nunc pro tunc, relating back to the date on which the judgment was originally entered and recorded. The court held that the judgment lien attached absolutely to assets of the judgment debtor's estate and provisionally to assets of his trust when the abstract of judgment was recorded.

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IV. STATUTES OF LIMITATIONS AND DUE PROCESS CONSIDERATIONS

§10.10 A. General 1-Year Limitations Period for Actions on a Liability of a Decedent Under CCP §366.2

Code of Civil Procedure §366.2 bars any action brought on a liability of a decedent, whether accrued or not accrued, if it is filed more than 1 year after the decedent's death, unless the limitations period is tolled or extended as discussed in §10.11.

NOTE: In *Estate of Yool* (2007) 151 CA4th 867, 60 CR3d 526, the court held that an action to declare that a decedent held title to property under a resulting trust was not subject to the 1-year limitations period of CCP §366.2 because the action was not an action on a liability of the decedent.

In *Stoltenberg v Newman* (2009) 179 CA4th 287, ___ CR3d ___, the court held that a suit against a successor trustee in her fiduciary capacity that was based on alleged fraud committed by the deceased predecessor trustee while acting as trustee was subject to the 1-year limitations period of CCP §366.2.

In *Bradley v Breen* (1999) 73 CA4th 798, 86 CR2d 726, the court held that CCP §366.2 barred a cross-complaint against a decedent's estate for equitable indemnity, despite the ordinary rule that an indemnity action does not accrue for statute of limitations purposes until a tort defendant pays a judgment or settlement for which that defendant is entitled to indemnity, although other equitable actions may still be allowed as occurred in *Battuello v Battuello* (1998) 64 CA4th 842, 75 CR2d 548. See §10.15.

This doctrine was reaffirmed in *Levine v Levine* (2002) 102 CA4th 1256, 126 CR2d 255, in which the court upheld the 1-year bar to deny any recovery from a trust created by the plaintiff's deceased grandfather, who had established investment accounts in appellants' names under the California Uniform Transfers to Minors Act (Prob C §§3900-3925). The court held that the 1-year bar of CCP §366.2 is not subject to delayed discovery or tolling based on minority or incapacity. See also *Farb v Superior Court* (2009) 174 CA4th 678, 94 CR3d 586 (child support claim based on surrogacy contract). But see *Evanson v Price* (ED Cal, Sept. 29, 2006, No. 2:06-CV-0795-GEB-KGM) 2006 US Dist Lexis 75029, in which the court held that CCP §366.2 was preempted by the Employee Retirement Income Security Act (ERISA) (29 USC §§1001-1461) in an action against the estate of a deceased administrator of an employee stock ownership plan (ESOP) for breach of fiduciary duty. See also *Board of Trustees of W. Conf. of Teamsters Pension Trust Fund v H.F. Johnson, Inc.* (9th Cir 1987) 830 F2d 1009; *Hemphill v Estate of Ryskamp* (ED Cal 2008) 619 F Supp 2d 954 (claim presentation requirement of Prob C §9351 preempted by ERISA).

NOTE: If CCP §366.3 may be involved, creditors should note that the 1-year limitations period under that section is tolled only by the bringing of an action (*e.g.,* to establish a constructive trust), and not by filing of a creditor's claim. See §10.17.

In *Embree v Embree* (2004) 125 CA4th 487, 22 CR3d 782, the court dismissed an action against the decedent's trust beneficiaries to enforce a marital settlement agreement as time-barred under CCP §§366.2 and 366.3. The opinion was authored by the same justice who wrote the opinion in *Arluk Med. Ctr. Indus. Group, Inc. v Dobler* (2004) 116 CA4th 1324, 11 CR3d 194 (*Dobler II*), in which the court held that the trustee had no obligation to retain trust assets to pay disputed claims against the decedent's probate estate. See §10.6.

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Source: Estate Planning/California Trust Administration/10 Creditors' Rights Against the Trust/§10.11 B. Interplay Between CCP §366.2 and Use of Trust Claims Procedure

§10.11 B. Interplay Between CCP §366.2 and Use of Trust Claims Procedure

The limitations period of CCP §366.2 can only be tolled or extended for the reasons enumerated in CCP §366.2(b):

- The last day of the period falls on a holiday, as specified in CCP §§12-12b (CCP §366.2(b)(1)).
- There is a timely filing of a claim in a probate proceeding (CCP §366.2(b)(2); Prob C §9352).
- There is a timely filing of a claim in a trust claims procedure initiated by the trustee (CCP §366.2(b)(3); Prob C §19253).

However, a creditor cannot compel the opening of a Prob C §§19000-19403 proceeding. Thus, if a creditor is concerned that the decedent's trustee may not initiate a trust claims procedure, the only remedy for a creditor is to open some sort of judicial proceeding, *e.g.,* by petitioning for appointment of a personal representative so that a probate estate proceeding is opened. See §10.12. Alternatively, the creditor may file a Prob C §850 petition. See §10.13.

WARNING: In *Wagner v Wagner* (2008) 162 CA4th 249, 75 CR3d 511, the court held that a successor trustee's cause of action for compensation for care of the deceased settlor was barred by the 1-year statute of limitations in CCP §366.2. However, there is no authority for the court's suggestion that the limitations period would have been tolled if the successor trustee had served herself with a written creditor claim, even though the trustee in *Wagner* did not use the trust claims procedure. The publication of the decision is unfortunate because the decision's dictum may mislead others to believe that it is not necessary for a claimant to file a court action seeking reimbursement within 1 year.

Because of the 1-year limitation imposed by CCP §§366.2-366.3, some attorneys representing trustees have concluded that it is unnecessary to use the optional trust claims procedure or a formal probate proceeding when one is not required. This view, however, overlooks constitutional due process and equitable estoppel or equitable tolling issues discussed in §§10.14-10.16.

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§10.12 1. Petition for Appointment of Creditor as Estate Administrator

Generally, unless the creditor knows that a will has been "lodged" with the superior court in the county of the debtor's residence (Prob C §§8200-8203), the creditor can file a petition for appointment of the creditor as administrator (Prob C §§8460-8469). See Prob C §§8000 (petition), 8461 (priority of appointment); see also Prob C §48 ("interested person" defined). The family or beneficiaries of the deceased debtor will then likely produce the will (which will point to the existence of any pourover trust). In the meantime, a judicial proceeding will have been opened, a case number assigned, and the avenue for filing the creditor's claim created. Once a creditor's claim is filed, the limitations period of CCP §366.2 will be tolled. Once a general personal representative has been appointed, a copy of the claim must be served on him or her.

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§10.13 2. Petition Under Prob C §850

Alternatively to filing a petition for appointment as estate administrator as discussed in §10.12, a creditor of the deceased settlor may claim that the trustee is in possession of real or personal property belonging to the creditor and file a petition under Prob C §850. See Prob C §850(a)(3)(A). (See also Prob C §850(a)(3)(C) with respect to trust property in which the creditor may have had a security interest.) A Prob C §850 petition involves a claim of title and is not technically a creditor's claim (as long as monetary damages are not sought); thus, CCP §336.2 or §336.3 may not be a barrier if the Prob C §850 proceeding is commenced more than 1 year after the decedent's death.

In *Estate of Myers* (2006) 139 CA4th 434, 42 CR3d 753, the court held that a creditor had standing to directly maintain a Prob C §850 proceeding to recover proceeds of a subsequent sale of property that had been fraudulently conveyed by a decedent whose estate was being administered in a probate proceeding, in a case in which the Prob C §850 petition was filed more than 5 years after the decedent's death. For a detailed discussion of Prob C §850 petitions, see chap 15.

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§10.14 C. Constitutional Due Process Issues

If a successor trustee to a decedent does not commence any formal trust claims procedure and there is no probate proceeding, a creditor not notified of the decedent's death may have no recourse if the creditor fails to make a claim within 1 year from the date-of-death limitations period of CCP §366.2, and the transferees may avoid liability as distributees of trust assets under Prob C §19400, as discussed in §10.7. See *Bradley v Breen* (1999) 73 CA4th 798, 86 CR2d 726, discussed in §10.10. The *Bradley* court, however, did not consider due process issues. In *Tulsa Prof. Collection Servs., Inc. v Estate of Pope* (1988) 485 US 478, 489, 99 L Ed 2d 565, 578, 108 S Ct 1340, the U.S. Supreme Court established the constitutional due process requirement of actual notice to known or reasonably ascertainable creditors. See §10.39. The question is whether the beneficiaries and other transferees of the trust settlor who retain personal liability for the decedent's debts are entitled to raise the statute of limitations defenses of CCP §366.2 or §366.3 (see §10.17) if such transferees never notified the known or reasonably ascertainable creditor of the death of the debtor, thus giving such creditor the opportunity to present a timely claim.

NOTE: The California legislature has recognized that actual notice is required to bar those claims against the surviving spouse that arise from debts incurred by a deceased spouse for necessaries of life, provided the surviving spouse had actual knowledge of the debts within the 1-year limitations period under Fam C §914(c). See *Collection Bureau of San Jose v Rumsey* (2000) 24 C4th 301, 99 CR2d 792.

It is uncertain whether the shortened limitations period under CCP §366.2 or §366.3 could withstand a constitutional challenge if a known or reasonably ascertainable creditor does not receive notice of the settlor's death and no probate or formal trust claims proceeding occurs. If the creditor brings suit against a transferee or trustee who raises the defense of a statute of limitations bar under CCP §366.2, the creditor's attorney should argue violation of the constitutional right to due process under *Tulsa*. Those representing the transferee or successor trustee should argue that there is no constitutional duty to notify creditors of "self-executing" statutes of limitations (*i.e.,* statutes of limitations that do not involve any state action beyond the enactment of the limitations period), such as CCP §366.2. These proponents should note that the court in *Tulsa* expressly applied the constitutional due process requirements to a statute that was not self-executing. However, because the duty to notify creditors is imposed as a constitutional rule of due process by *Tulsa,* the author would argue that the California legislature may not permit the cutoff of a right to bring suit against the transferee when there has been no actual notice to the potential creditor.

PRACTICE TIP: Guaranties and other contingent and unaccrued claims may cause liability to accrue long after death. See *Borba Farms, Inc. v Acheson* (1988) 197 CA3d 597, 242 CR 880. The personal representative or trustee, or a trust beneficiary if the trustee does not proceed under Prob C §§19000-19403, should consider sending a written notice form to any "known or reasonably ascertainable creditor," including one with whom the decedent may have had a business or lending activity, so that if no claim is timely filed within 1 year after the settlor's death, the trustee, or trust beneficiary can later raise the defense of a barred claim under CCP §366.2 even if the holder of the guaranty or other future arising entitlement later argues that such obligation is allowable under the *Tulsa* due process doctrine based on lack of actual notice of the shortened limitations period. See *Shelley v Kraemer* (1948) 334 US 1, 92 L Ed 1161, 68 S Ct 836 (no state statute can overcome constitutionally protected right).

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§10.15 D. Equitable Estoppel

Equitable considerations can sometimes override a statute of limitations. In the past, the courts have been liberal in construing statutes of limitations to permit otherwise barred claims. Therefore, it may be imprudent to assume that creditors' claims will be barred under CCP §366.2, instead of seeking the specific protections afforded by the trust creditor claims procedures or a formal probate proceeding. Further, as discussed in §10.14, CCP §366.2 may be subject to federal constitutional due process challenges.

Except for *Bradley v Breen* (1999) 73 CA4th 798, 86 CR2d 726 (see §10.10), case law has tended to allow the filing of causes of action against a decedent's estate, trust, or other successors in interest when a breach of a promise is alleged and the principles of equitable estoppel apply. See, *e.g., Battuello v Battuello* (1998) 64 CA4th 842, 75 CR2d 548. Appellant had filed a complaint against his mother, both individually and in her capacity as trustee of a family trust, and against his deceased father's estate, seeking to establish an interest in a Napa County vineyard that he claimed his father had promised to give to him. Appellant's mother, acting individually, as trustee of the trust, and apparently on behalf of her husband's estate, demurred to the complaint, arguing that the complaint was barred by CCP §366.2 because more than 1 year had elapsed since his death. The trial court agreed and sustained the demurrer without leave to amend. The court of appeal reversed based on a theory of equitable estoppel. The court stated that equitable estoppel (64 CA4th at 847)

> is not concerned with the running and suspension of the limitations period, but rather comes into play only after the limitations period has run and addresses itself to the circumstances in which a party will be estopped from asserting the statute of limitations as a defense to an admittedly untimely action because his conduct has induced another into forbearing suit within the applicable limitations period.

NOTE: In *Bradley v Breen* (1999) 73 CA4th 798, 803, 86 CR2d 726, the court stated that the *Battuello* decision held that "when the decedent's representative has induced a claimant not to file a suit within the limitations period of §366.2, the doctrine of equitable estoppel may be applied to toll the statute." The above-quoted language from *Battuello* takes a broader view of equitable considerations. However, the scope of the *Battuello* decision has been limited by the enactment of CCP §366.3. See §10.17.

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§10.16 E. Equitable Tolling if Creditor Pursued Other Remedy Within 1 Year

Some practitioners believe that the doctrine of "equitable tolling" also might be used to permit the bringing of an action against a trust or probate estate even if a claim was not timely filed, provided the creditor was pursuing some other sort of remedy that commenced in the initial 1-year period following death. The doctrine of equitable tolling is explained in *Lambert v Commonwealth Land Title Ins.Co.* (1991) 53 C3d 1072, 282 CR 445, and was further enunciated in *Stalberg v Western Title Ins. Co*. (1994) 27 CA4th 925, 932, 32 CR2d 750. Although neither of these cases involved claims against a trust or probate estate, a court might apply the equitable tolling doctrine in such a case if the judge feels that his or her sense of justice is constrained by the strict application of a statute of limitations.

In *Burgos v Tamulonis* (1994) 28 CA4th 757, 33 CR2d 728, a pedestrian filed a personal injury action against a motorist and, after learning later of the motorist's death, properly filed an amended complaint naming the personal representative of the motorist's estate as defendant. The amended complaint was filed more than 1 year after the motorist's death. The court of appeal held that the amended complaint related back to the filing of the original complaint naming the motorist as a defendant, which had been filed within 1 year of the motorist's death, as now required by CCP §366.2.

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§10.17 F. Special 1-Year Limitations Period for Actions Based on Decedent's Promise Under CCP §366.3

Under CCP §366.3, any action to enforce a claim arising from a promise or agreement with a decedent for distribution from an estate or trust or under any other instrument, whether the promise or agreement was oral or written, must be brought within 1 year after the date of death, and the limitations period that would have been applicable does not apply. This statute thus limits the scope of the earlier case law regarding equitable estoppel, particularly *Battuello v Battuello* (1998) 64 CA4th 842, 75 CR2d 548 (see §10.15), and *Estate of Brenzikofer* (1996) 49 CA4th 1461, 57 CR2d 401 (trial court improperly ordered summary judgment against neighbors who claimed decedent had made oral promise to make will leaving them house they had rented from her in return for taking care of her).

The limitations period provided in CCP §366.3 for commencement of an action is not tolled or extended for any reason except as provided in CCP §§12-12b (if last day of limitations periods falls on holiday). This exception also applies, among other exceptions, to the limitations period in CCP §366.2. See §10.11. However, CCP §336.3 does not provide that filing a creditor's claim is grounds for tolling the statute of limitations, unlike the provisions in CCP §366.2. See *Stewart v Seward* (2007) 148 CA4th 1513, 56 CR3d 651 (action alleging breach of will contract). Thus, it is possible that a plaintiff in a will contract case or other action on a contract to transfer specific property must comply with the creditor's claim statutes if a probate proceeding or trust claims procedure is initiated (see *Wilkison v Wiedwekehr* (2002) 101 CA4th 822, 124 CR2d 631), but the tolling provisions that ordinarily apply to such claims may not be applicable.

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V. CLAIMS OF PUBLIC CREDITORS

§10.18 A. Claims of California Public Entities

Claims of California public entities are subject to the specific notice requirements and claim filing deadlines in Prob C §§19200-19205. Unlike the trust claims procedure in general, these provisions are not optional. See Prob C §19003(c). "Public entity" under Prob C §§19200-19205 is defined in Govt C §811.2, and includes an officer authorized to act on behalf of the public entity. Prob C §19200(b).

Probate Code §§19200-19205 were copied almost verbatim from the probate claims statutes (Prob C §§9200-9205). Therefore, case precedents and administrative regulations interpreting the probate claims statute should also apply to trust claims. See, *e.g.*, *Shewry v Wooten* (2009) 172 CA4th 741, 91 CR3d 199 (notice requirements and claim filing deadlines for claims made by Department of Health Care Services (DHCS) are those contained in Prob C §§9200-9205; the more general creditor claim notice and deadline requirements for probate claims are not applicable). See discussion of Medi-Cal notice requirements in §10.19.

Notice must be sent to the appropriate agencies to bar their potential claims. Prob C §19201(a)(2). If the agency prescribes a particular form of notice, this form must be used; the statutes of limitations imposed by the respective governing statutes, which are listed in Prob C §19201(b), take precedence over the usual filing rules of the trust claims law. Prob C §19201. An agency that receives proper notice must file its claim within the applicable time or its claim, including any lien imposed for the claim, is barred. Prob C §19200. If property is distributed before the claims filing period expires, the public entity has a claim against the distributees, and the claim includes interest. Prob C §19203. On the requirement of notice to the California Victim Compensation and Government Claims Board in the case of incarcerated heirs, see §10.20.

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§10.19 1. Notice to Director of Health Care Services

Notice must be sent to the State Director of Health Care Services if the trustee knows or has reason to believe that the deceased settlor received Medi-Cal benefits or that the deceased settlor was the surviving spouse or registered domestic partner of a person who received those benefits, and the Director has 4 months after notice is given to file a claim. Prob C §19202; Fam C §297.5(c).

A frequent claim for decedents who received state aid under the Medi-Cal program (known as Medicaid in most other states) is a demand for recovery of such health care payments. See Welf & I C §14009.5. There are some exceptions, but even if the decedent's predeceased spouse or partner rather than the decedent received Medi-Cal benefits, there could be a claim. Therefore, notice to the Director of Health Care Services is prudent in every trust estate unless the trustee is certain that no Medi-Cal benefits were received, even if notice is not required by Prob C §19202 and formal publication of a notice to creditors is not made.

The general 3-year statute of limitations under CCP §338(a) (not the 1-year period under CCP §366.2) applies to an action based on the statutory liability for Medi-Cal benefits. The 3-year period does not even begin to run until the required notice under Prob C §215 is sent to the Director of Health Care Services, and the equitable defense of laches is not available to the party liable for the reimbursement of Medi-Cal payments. *Shewry v Begil* (2005) 128 CA4th 639, 27 CR3d 209. Furthermore, the Department of Health Care Services is entitled to recover prejudgment interest. 128 CA4th at 646.

An exception to recovery for Medi-Cal payments exists if the Medi-Cal beneficiary's estate (here, the remaining assets of a special needs trust) passes to an adult disabled child. *Shewry v Arnold* (2004) 125 CA4th 186, 22 CR3d 488. Nevertheless, it would be prudent to send the notice of the beneficiary's death to the Director of Health Care Services, with information on the new special needs trust or other provision for the adult disabled child, so that the 3-year limitations period commences to run.

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Source: Estate Planning/California Trust Administration/10 Creditors' Rights Against the Trust/§10.20 2. Notice to the Director of California Victim Compensation and Government Claims Board

§10.20 2. Notice to the Director of California Victim Compensation and Government Claims Board

An estate attorney, beneficiary, personal representative, or person in possession of a decedent's property, which would include the trustee, is required to send written notice to the Director of the California Victim Compensation and Government Claims Board within 90 days after the death of the decedent when the decedent has an heir who is incarcerated. Prob C §216. (The notice requirement appears to apply even though there is no provision in the Trust Law sections regarding claims by public entities parallel to the one in Prob C §9202(b) for formal probate administration.)

The law specifies "heir," which may not mean a trust beneficiary per se, but the status of beneficiaries needs to be checked. (Under Prob C §44, an "heir" is defined as a person entitled to take property by intestate succession.) While this notice requirement is similar to the concept used for Medi-Cal recoveries (see §10.19), the focus is on heirs. The Director of the Board has 4 months after the notice is received to pursue collection of any outstanding restitution fines or orders against that heir. Because heirs are not always beneficiaries of an estate, this additional requirement will likely marginally increase the cost of estate administration whenever the Board attempts to pursue collection efforts for outstanding restitution fines.

The notice must include the name of the heir, place of incarceration of the heir, the heir's CDCR number if incarcerated in a Department of Corrections and Rehabilitation facility or booking number if incarcerated in a county facility, a copy of the decedent's death certificate, the probate case number (if any), and the name of the court hearing the case. Prob C §216.

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§10.21 B. Claims of California Tax Authorities

The Franchise Tax Board must assess income tax on the decedent or the decedent's estate within 18 months after written request (filed after the return is made) by the fiduciary of the estate or trust or by any other person liable for the tax. Rev & T C §19517. If such a written request for an earlier determination is not made, then the trustee and the beneficiaries face the usual rule for transferee liability imposed by Rev & T C §19074, which generally provides that the transferee or fiduciary remains liable for 1 year after the expiration of the limitation period for assessment against the taxpayer (or 1 year after the expiration of the limitation period for assessment against the preceding transferee, but only if within 3 years after the expiration of the limitation period for assessment against the taxpayer). The limitation period for income tax examinations and assessments is 4 years. Rev & T C §19057(a). In other words, the state can have an extra year beyond the usual 4-year statute of limitation for income tax examinations and assessments. Although no California cases interpret the transferee liability rules, it can safely be assumed that the federal case law will be followed because the state law on the additional time in which to seek transferee liability is similar to the federal law. See §10.23.

NOTE: If a surviving spouse signed a joint tax return, or if someone is otherwise directly liable (*e.g.,* a surviving partner), the rules on transferee liability do not apply. The surviving taxpayer is directly and severally liable.

Revenue and Taxation Code sections providing notice and claim periods for sales and use tax and other excise taxes are further specified in Prob C §19201(b). If a probate proceeding is initiated, notice of administration of the estate must be sent to the Franchise Tax Board within 90 days after the date letters are first issued to a general personal representative. Prob C §9202(c). However, there is no parallel provision in the Trust Law requiring notice to the Franchise Tax Board when the trust claims procedure is used.

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§10.22 C. Other California Public Creditors

There are a variety of other government claims for which Revenue and Taxation Code sections provide notice and claim periods as specified in Prob C §19201(b) (see §10.21), such as the sales and use tax (Rev & T C §6487.1). However, not every type of government claim will come within Prob C §§19201-19205. In such a type of proceeding (*e.g.,* a city or county action), the public creditor is subject to the regular claims procedure in Prob C §§19001-19403.

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§10.23 D. Claims of Federal Tax Authorities

While California income tax, sales tax, and other specified taxes are given special treatment under Prob C §19201 (see §10.21), federal taxes are not specifically mentioned in that statute. The following general reference in Prob C §11420(a), however, sets out the priority of payment of debts:

> Debts shall be paid in the following order of priority among classes of debts, except that debts owed to the United States or to this state that have preference under the laws of the United States or of this state shall be given the preference required by such laws.

Federal tax law provides for recovery of a decedent's tax liability against any transferee taking property of the deceased. IRC §6901; Treas Reg §301.6901-1. On fraudulent conveyances, see §10.24. There is an additional 1-year period following the running of the normal period of assessment (generally 3 years from the date of filing a return) against the decedent. IRC §6901(c). The IRS is not bound by state statutes of limitations. See §10.25.

The liability owed to the IRS can exceed the fair market value of the property received, because the amount owed can include interest on the retention of the assets. *Larry D. Delpit,* TC Memo 1992-297. However, not all transfers are treated the same, and some types of nonprobate transfers, such as joint tenancy survivorship property (*Tooley v Commissioner* (9th Cir 1941) 121 F2d 350; *U.S. v Vittaly* (ND Cal 2006) 2007-1 USTC ¶50,295, 99 AFTR2d 342; *Christine D. Muller* (1948) 10 TC 678) and life insurance proceeds funded by the decedent (*Commissioner v Stern* (1958) 357 US 39, 2 L Ed 2d 1126, 78 S Ct 1047), receive greater immunity than trust transfers.

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§10.24 1. IRS May Recover on Fraudulent Conveyances

The IRS can seek recovery as would any creditor using the local state's law on fraudulent conveyances. *U.S. v Truax* (5th Cir 1955) 223 F2d 229 (applying Georgia law); *Shirley T. Hagaman* (1993) 100 TC 180. The statute of limitations on pursuing a claim for fraudulent conveyance has been held to be the longer of 7 years from the date of transfer (under the provisions of the Uniform Fraudulent Transfer Act (CC §§3439-3439.12)) or 3 years from the date of discovery of the fraudulent act (under the provisions of CCP §338(d)). See *Macedo v Bosio Revocable Trust* (2001) 86 CA4th 1044, 104 CR2d 1. In addition, the federal government can use general equitable principles to enforce the recovery. *Viles v Commissioner* (6th Cir 1956) 233 F2d 376. This would authorize the longer of the applicable federal or California periods for commencing an action.

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§10.25 2. IRS Not Bound by State Statutes of Limitations

In any event, "[i]t is well settled, regardless of whether the claim is filed in federal or state court, that the United States is not bound by state statutes of limitations in enforcing its rights." *U.S. v Summerlin* (1940) 310 US 414, 416, 84 L Ed 1283, 1285, 60 S Ct 1019; *U.S. v Guyton* (MD Fla 2009) 103 AFTR2d 2112 (statement of claim for decedent's unpaid tax liability filed 7 years after death); *Baciagalupo v U.S.* (MD Tenn 2005) 399 F Supp 2d 835 (proof of claim for unpaid income taxes for decedent's last 7 years filed after expiration of 12-month filing period for filing claims against estate in Tennessee probate proceeding).

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VI. TRUST CLAIMS PROCEDURE

A. Using Trust Claims Procedure

§10.26 1. When Trust Claims Procedure May Be Used

The trust claims procedure in Prob C §§19000-19403 may be initiated by the trustee following the settlor's death. The procedure is modeled on the Prob C §§9000-9399 creditor claims procedure used in decedent estate administration. See 2 California Decedent Estate Practice, chap 14 (2d ed Cal CEB 2009). The trust claims procedure provides a comprehensive scheme for resolution of claims against the trust, but the procedure is not often used.

The trust claims procedure is *optional* and may be used only when:

- No formal probate administration (see §10.27) has occurred and, as far as the trustee has actual knowledge, no petition has been filed to administer the estate of a deceased settlor (Prob C §19003(a)); and
- At least one trust (see §10.28) was revocable by the settlor at the time of death (Prob C §19001(a)).

Trustees have no duty to use the trust claims procedure and opinions vary on whether they should. Counsel for institutional and private professional trustees may recommend the procedure as a means to reduce uncertainty over which creditors may be paid. Although trustees are not liable if they forgo the procedure (Prob C §19010), institutional and private professional trustees may prefer to avoid raising this defense. By using the optional procedure, these trustees eliminate distributee liability and consequently eliminate the possibility that a distributee might erroneously cross-complain against the trustee. By contrast, so-called "interested" trustees who are also beneficiaries of the trust may prefer to avoid notifying creditors and thereby facilitating their claims against the trust assets.

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§10.27 a. Priority of Probate Administration

The priority of the formal probate administration was clearly demonstrated in *Dobler v Arluk Med. Ctr. Indus. Group, Inc.* (2001) 89 CA4th 530, 107 CR2d 478 (*Dobler I*), in which the court held that a valid creditor's claim filed in the decedent debtor's probate estate can be satisfied out of assets of the decedent's revocable trust when probate assets are insufficient, without any requirement that the creditor file a separate and timely claim against the trust.

NOTE: Although a probate proceeding *preempts* the use of the trust claims procedure, the probate provides immunity for untimely filed claims against assets in any revocable trusts. Prob C §§9351, 19006(b). See §10.5.

Conversely, if a probate proceeding is opened after the trustee initiated the trust claims procedure (*i.e.*, after filing and publication of notice under Prob C §19003), the trustee can recover from the probate estate for any debts paid that would otherwise have been paid by the probate estate. Prob C §19006(c).

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§10.28 b. Multiple Revocable Trusts

If there are multiple revocable trusts, the protection afforded by the use of the trust claims procedure extends to any other trusts established by the deceased settlor and to the trustees and beneficiaries of those trusts. The protection flows to all of the settlor's trusts, including those whose trustees do not petition to establish a claims procedure. Prob C §19006(a). The trustee who files a claims notice can seek apportionment among remaining trusts. Prob C §19020(b).

If a settlor has created more than one revocable trust, the settlor can specify which trust should bear the liability for his or her debts. Prob C §19001(b). Otherwise, proration based on relative trust values governs the apportionment of debts.

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§10.29 2. When Trust Claims Procedure May Be Advisable

The trustee should consider using the Prob C §§19000-19403 trust claims procedure in the following cases:

- When the trust will be distributed on the death of the settlor, and the distributees, or those receiving the bulk of the assets, reside outside the state or the country. Although Prob C §19400 clearly provides for transferee liability, a creditor may conclude that it is easier to sue a resident trustee rather than the distributees of the property who reside in other jurisdictions. Although such a suit against the trustee should be dismissed, the trustee will still incur unnecessary legal expense to move to dismiss the claim. Rather than risk involvement in such a lawsuit, the trustee may choose to use the trust claims procedure. See §10.7.
- By similar reasoning, if there are a small number of in-state beneficiaries, the use of the optional trust claims procedure may forestall a later attempt by the creditor to pursue individuals, and the costs of defending the claims will be expenses of administration that may prove to be a valuable deduction on either the federal estate tax return (IRS Form 706) or on the trust's fiduciary income tax returns (IRS Form 1041 and FTB Form 541).

NOTE: The trustee must elect on which return to claim these deductions; they cannot be claimed for both estate tax and income tax purposes. See chap 11.

- When the trust will continue for other beneficiaries. Use of the trust claims procedure will assure the trustee that the claims have been foreclosed, at least with respect to creditors who are not known or reasonably ascertainable. See §10.14. The trustee can then go forward with investment changes or restructuring of the trust portfolio to suit the needs of the new class of beneficiaries without worrying about outstanding claims.
- When it would provide peace of mind to the beneficiaries. Even when the potential risk of creditor claims is small, it reassures beneficiaries to know that all legitimate known debts are dealt with and that remote and contingent claims can be cut off within a finite period.
- When it is known that claims are outstanding against the settlor. Use of the procedure will hasten the filing of claims and settling outstanding liabilities of the trust estate.

NOTE: If the trustee fails to use the trust claims proceeding, the beneficiaries of the trust will be individually liable as transferees. Prob C §19400. See §10.7. (If the trust claims procedure is used, trust beneficiaries will be liable only if notice was not properly given to the creditor. Prob C §19401. See §10.33.)

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§10.30 3. Protecting Property of Surviving Spouse or Domestic Partner

In probate administration, if the surviving spouse's or registered domestic partner's share of community property is also administered, the surviving spouse or partner is protected from unfiled or untimely filed creditors' claims. Prob C §§13502, 13553; Fam C §297.5(c). Such an election to have the survivor's share of property administered in the probate estate must be made within 4 months after the issuance of letters. Prob C §13502(b). See *Estate of Bonanno* (2008) 165 CA4th 7, 80 CR3d 560 (settlement agreement concerning estate administration estopped surviving spouse from claiming property by spousal property petition when election was not made). The trust claims procedure does not appear to provide for the election to subject the surviving spouse's share of community property held in the trust to claims, as can be done for probate estates. Prob C §§13502, 13553. The trust claims law, however, does provide that a cutoff of claims extends to all trusts created by the settlor. Prob C §19006(a). Therefore, if the two spouses are the joint settlors of a funded trust that contains substantially all of their assets, creditor claims protection may be available. This result, however, is uncertain because the relationship between the trust claims rules and the general rules regarding apportionment of debts between the spouses is not as clear as in formal probate administration. See §10.31.

PRACTICE TIP: If total protection for a surviving spouse or registered domestic partner is desired, the only clear and proven method is to have all community property pass by will and to elect administration on both halves under Prob C §13502. The decision in *Dobler v Arluk Med. Ctr. Indus. Group, Inc.* (2001) 89 CA4th 530, 107 CR2d 478 (*Dobler I*) is silent on the liability of community property of surviving spouses and domestic partners, but logic dictates that if both halves of the community assets are administered in a formal probate, and a claim is not timely filed in that proceeding, the balance of community property in a revocable trust should be immune from creditors' claims under Prob C §19006(b). See §10.5.

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§10.31 4. Apportionment of Liability for Marital or Domestic Partnership Debts

The surviving spouse's liability for debts of the deceased spouse under the trust claims procedure is determined by the general spousal liability provisions of the Probate Code. See Prob C §19330, which refers to Prob C §13550. Under Prob C §13550, the surviving spouse is personally liable for the debts of the deceased spouse unless the claims are barred by administration of the decedent's trust or estate or the debts are allocated to the trust or estate. Under Fam C §297.5(c), these rules also apply to surviving registered domestic partners.

There may be a serious limitation in using the trust claims procedure to protect the surviving spouse or partner from liability for the debts of the deceased spouse or partner because there is no trust claims statute similar to Prob C §13553, under which a surviving spouse or partner may elect to have his or her half of the community administered along with the decedent's portion. This election is the only way to ensure complete immunity. See §10.30. If a creditor files a timely claim, the decedent's property that would pass to the surviving spouse or partner (whether community, quasi-community, or separate property) will be subject to such claims. Prob C §19330.

The trust claims procedure does provide for the allocation of debts between the trust estate and the surviving spouse or partner or the deceased settlor's probate estate. Prob C §§19320-19326. Allocation frequently occurs when the decedent leaves his or her estate to others, such as the children of a previous marriage. The trustee, personal representative, if any, of a deceased settlor's probate estate, and the surviving spouse or partner may provide for allocation of debts by agreement as long as the agreement substantially protects the rights of other interested persons. Prob C §19324(a). The trustee, the personal representative, or the surviving spouse or partner may request and obtain court approval of the allocation provided in the agreement. Prob C §19324(a).

In the absence of an agreement, debts are allocated between the two spouses or partners following general liability rules in both formal probate and under the trust claims procedure. Prob C §§11444(b), 19324(b). Probate Code §19324(b) provides that, in the absence of an agreement, in allocating debts between a decedent's estate (including a trust) and the surviving spouse or partner, the court must first characterize the debts as separate or community. The court must then allocate the separate or community debts to assets similarly characterized. If the net value of either spouse or partner's separate property assets is less than that spouse or partner's unsecured separate property debts, the unsatisfied portion of the debts must be allocated to that spouse or partner's one-half share of the community property assets. If the net value of that spouse or partner's one-half share of the community property is less than the spouse or partner's unsatisfied and unsecured separate debt, the remaining unsatisfied portion of the debt must be allocated to the net value of the other spouse or partner's one-half share of the community property. The court, finally, may order a different allocation of debts among the deceased settlor's probate estate, trust, and the surviving spouse or partner if the court finds a different allocation is equitable under the circumstances. Prob C §19324(d).

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§10.32 5. Avoiding Payment of Family Allowance

When no probate has been filed, it is clear that a court cannot order a trustee to pay a family allowance. See *Parson v Parson* (1996) 49 CA4th 537, 56 CR2d 686. Furthermore, notwithstanding dictum in *Parson* to the contrary, if the court orders a family allowance in a probate and the assets administered are insufficient to pay all or part of the allowance, the court probably cannot order the trustee to pay the difference. The family allowance is a right created by statute that allows for payment out of the decedent's "estate" and only during the "administration of the estate." Prob C §6540(a). Unlike "claims of creditors" and "expenses of administration," which trustees must pay when the decedent's estate is insufficient (Prob C §19001), there is no statutory requirement that trustees pay a family allowance. The fact that the legislature used these narrow, well-defined terms suggests that trustees cannot also be made to pay family allowances. Had the statute instead required trustees to pay "debts" of the decedent, one might reach a contrary conclusion, because "debts" encompass claims, expenses of administration, and family allowances. See Prob C §11401.

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§10.33 6. Remedy for Creditors Not Given Notice (Prob C §19401)

Even if the trustee uses the trust claims procedure, a creditor may pursue recovery from a distributee of property, but only under the following narrow circumstances (Prob C §19401):

- The trustee knew, or reasonably should have known, the creditor's identity within 4 months after first publication of notice, and the creditor's claim was not merely conjectural. See §10.39.
- The trustee did not give the creditor the required form of notice and neither the creditor nor the creditor's attorney had actual knowledge of the trust administration sooner than 1 year after the date of the first publication of notice. See §10.44.
- The creditor commences an action against the distributee before the expiration of the statute of limitations applicable under CCP §366.2 (generally 1 year from the decedent's date of death). See §§10.11-10.14.

NOTE: A claim based on a promise or agreement by the decedent to provide for a third party is not truly a claim against the decedent. Such a claim must be brought against the parties who would otherwise inherit from the decedent, *e.g.,* in a complaint for constructive trust or a similar equitable proceeding, within 1 year of the date of death. CCP §366.3.

If the trust has been partially but not completely distributed, the beneficiary's personal liability is limited to (1) amounts that cannot be satisfied from the as yet undistributed trust estate and (2) a prorata portion of the creditor's claim, based on the amount of the beneficiary's distribution and the total trust distributions, not to exceed the amount received by the beneficiary. The creditor should commence a regular civil suit alleging the transferee's personal liability under the applicable statute. Any defenses that would have been available to the deceased trust settlor may be raised by his or her successor in interest. Prob C §19402.

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§10.34 7. Creditor Claims and No-Contest Clauses

Although the law governing no-contest clauses changed dramatically on January 1, 2010, with respect to instruments that became irrevocable on or after January 1, 2001, a no-contest clause may still be enforced against the filing of a creditor's claim if the clause expressly provides for that application. Prob C §21311(a)(3). Attorneys who represent creditors must proceed with special caution because it is no longer possible to seek declaratory relief with respect to those instruments before filing a creditor's claim.

The common law continues to govern enforcement of a no-contest clause to the extent that Prob C §21311 does not apply. Prob C §21313. See, *e.g.*, *Tunstall v Wells* (2006) 144 CA4th 554, 50 CR3d 468 (no-contest clause enforced providing that contest would result in forfeiture not only of gift to contestant, but also of gifts to contestant's siblings); *Estate of Ferber* (1998) 66 CA4th 244, 77 CR2d 774 (no-contest clause that penalizes beneficiaries who attempt to remove executor violates public policy except in cases where removal attempt is frivolous for instruments that became irrevocable before 2001).

In *Johnson v Greenelsh* (Oct. 29, 2009, S166747) 2009 Cal Lexis 11392, the California Supreme Court held that a beneficiary and co-trustee did not violate a trust's no-contest clause under former law when she challenged the surviving settlor's withdrawal of trust property and appointment of a successor trustee to serve as co-trustee, in accordance with the terms of the trust document, on the basis of the survivor's alleged incapacity.

In *Cook v Cook* (2009) 177 CA4th 1436, 99 CR3d 913, the court held that a beneficiary violated a trust's no-contest clause under former law by attempting to obtain a court decree that his distribution share was not reduced by the amount of his indebtedness because it was barred by the statute of limitations, but a no-contest clause would not be enforceable in similar circumstances under Prob C §21311.

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B. Commencing Trust Claims Procedure

§10.35 1. File Notice and Pay Fee

To initiate the trust claims procedure, the trustee must file a proposed notice to creditors form with the court clerk and pay the filing fee. Prob C §19003(a). The form of the prescribed notice is the same for publication and for mailing or personal delivery to creditors. Prob C §§19040(b), 19052. See §10.37 for a sample form.

PRACTICE TIP: The attorney needs to coordinate the date of first publication of the notice with the newspaper before proceeding to file the notice so that the form filed with the court clerk contains the correct date. See §10.38.

On payment of the case filing fee, the clerk will assign a case number to the notice form. The fee is the same ($355) as that for filing a petition for probate. See Govt C §70655. Some counties may also impose a separate hearing fee for the petition to allow claims.

PRACTICE TIP: There is no requirement that a copy of the trust or an inventory of trust assets be filed with the court or supplied to parties receiving notice. See Prob C §19024. Therefore, a trust claims procedure can provide more privacy than is the case with formal probate, in which the will and inventory are open to public scrutiny. A creditor, however, may file a request for special notice of specified proceedings under Prob C §17200. Prob C §17204.

Proper venue for filing the notice is the superior court for the county in California where the deceased settlor resided at the time of death; or, if none, in any county in California where trust property was located at the time of the settlor's death; or if none, in the California county that was the principal place of administration of the trust at the time of the settlor's death. Prob C §19003(b).

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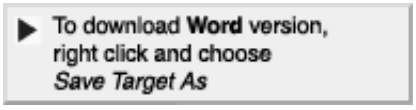
§10.36 2. Form of Notice; Comparison With Probate Notice

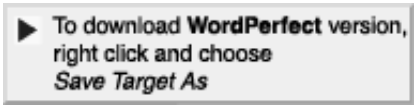
The form of notice is prescribed by statute (Prob C §§19040(b), 19052) and is similar to, but slightly different from, the notice to creditors in formal probate administration (Prob C §9052):

- The trust claims procedure differs from probate in that there are no Judicial Council forms published to date for trust claims, even though such forms are authorized by Prob C §19011. Therefore, the notice to creditors under Prob C §19052 should be prepared on normal lined pleading paper. See Cal Rules of Ct 2.108.
- The Judicial Council Form DE-157 (Notice of Administration to Creditors) used in probate proceedings contains language strongly recommending that the attorney furnish each creditor with a claims form. There is no such requirement for trusts under Prob C §19052. See form in §10.37.
- The trust notice advises creditors that they may file a claim before expiration of the later of 4 months after the first date of publication or 60 days after actual notice is mailed or personally delivered to the creditor. Prob C §19100(a). Creditors in probate proceedings also have 60 days after the date notice of administration is mailed or personally delivered to the creditor to file a claim and 4 months after letters are first issued to a general personal representative. Prob C §9100(a)(2).

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§10.37 3. Form: Notice to Creditors





SUPERIOR COURT OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In re the _ _[*name*]_ _ Trust created _ _[*date*]_ _ by _ _[*name*]_ _, Decedent.	**Case No. _ _ _ _ _ _** **NOTICE TO CREDITORS** **(PROB C §§19040(b), 19052)**

Notice is hereby given to the creditors and contingent creditors of the above-named decedent that all persons having claims against the decedent are required to file them with the Superior Court, at _ _[*address*]_ _, and mail or deliver a copy to _ _[*name*]_ _, as trustee of the trust dated _ _[*date*]_ _, of which the Decedent was the settlor, at _ _[*address*]_ _, within the later of 4 months after _ _[*date of first publication of notice to creditors*]_ _ (the date of the first publication of notice to creditors) or, if notice is mailed or personally delivered to you, 60 days after the date this notice is mailed or personally delivered to you, or you must petition to file a late claim as provided in Probate Code §19103. A claim form may be obtained from the court clerk. For your protection, you are encouraged to file your claim by certified mail, with return receipt requested.

_ _[*Date of mailing this notice, if applicable*]_ _

__[*Signature*]__
_ _[*Typed name*]_ _,
Trustee of the _ _[*name*]_ _Trust, dated _ _[*date*]_ _

_ _[*Address of trustee*]_ _

Comment: The notice may be signed by the attorney for the trustee and the attorney's address may be used. See Prob C §19052.

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§10.38 4. Publication of Notice

Under the trust claims procedure, as required in a probate proceeding (Prob C §8121), notice must be published at least three times in a newspaper published at least once a week, within 15 days, with at least 5 days intervening between first and last publication, not counting the first and last publication dates as part of the 5-day period. Prob C §19040(a). The form of the notice is prescribed by Prob C §19040(b) and is substantially identical to the prescribed form of actual notice to creditors under Prob C §19052. See §10.37.

The trustee, or his or her attorney, must arrange for publication of the notice in a newspaper of general circulation in the city, county, or city and county in California where the deceased settlor resided at the time of death; or if none, in the city or county, or city and county in California where trust property was located at the time of the settlor's death; or if none, in the city, county, or city and county in California where the principal place of administration of the trust was located at the time of the settlor's death. If no newspaper of general circulation is published in the applicable city, county, or city and county, notice must be published in a newspaper of general circulation published in California nearest to the applicable city, county, or city and county seat, and that is circulated within the applicable city, county, or city and county. If no such newspaper of general circulation exists, notice shall be given in written or printed form posted at three of the most public places within the community. Prob C §§19003(a), 19040(a). This requirement is similar to those for publication in probate administration. Prob C §8121.

NOTE: Because no hearing date is connected to this publication date, there should be fewer problems in using weekly community newspapers under the optional trust claims procedure than in a formal probate administration.

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C. Giving Notice to Creditors

§10.39 1. Duty to Notify Known or Reasonably Ascertainable Creditors

In addition to the publication requirement discussed in §10.38, the trustee must send notice to "known creditors." A creditor is known if the trustee is aware that the creditor has demanded payment from the deceased settlor or the trust estate. Prob C §19050(a). There currently is no statutory obligation to search for creditors. Prob C §§19050, 19053. This differs from the rules for probate proceedings, which require the personal representative to notify "all known and reasonably ascertainable" creditors. Prob C §9050.

Claims procedures, however, that involve the probate court, whether used in the context of a probate proceeding or as part of a trust administration, involve state action that is so substantial that they are subject to the restrictions of the Fourteenth Amendment. *Tulsa Prof. Collection Servs., Inc. v Estate of Pope* (1988) 485 US 478, 487, 99 L Ed 2d 565, 576, 108 S Ct 1340. Appropriate notice, in other words, is a constitutional requirement. The United States Supreme Court has held that a person handling an estate has a duty to notify all "known or reasonably ascertainable creditors." 485 US at 489, 99 L Ed 2d at 578. Inasmuch as the duty to ascertain creditors and to give them actual notice is based on federal constitutional law, the author would argue that a trustee should exercise the same due diligence he or she would if serving as an executor or administrator. See *Clark v Kerby* (1992) 4 CA4th 1505, 6 CR2d 440.

PRACTICE TIP: A useful method of ascertaining all likely creditors is to search through the decedent's mail for any bills, indications of open accounts, and the like. Send notices to all health care providers of the decedent, including those who may not have been providing treatment for the final illness. Send notices to the personal attorney, accountant, insurance broker, stock broker, and other financial professionals for the deceased. Also consider sending notices to all family members, friends, and neighbors who may have provided services to the decedent. See 2 California Decedent Estate Practice §14.10 (2d ed Cal CEB 2009).

The trustee need not, however, consider every potential claim. It is not necessary to inspect a deceased physician's medical records or a deceased attorney's client files to determine whether malpractice may have occurred. The U.S. Supreme Court has held that no notice need be sent to potential creditors who are merely "conjectural." *Tulsa Prof. Collection Servs., Inc. v Estate of Pope* (1988) 485 US 478, 490, 99 L Ed 2d 565, 578, 108 S Ct 1340. This rule is codified in the distributee liability provisions of Prob C §19401. See §10.33. Sending notice to all of the patients of a deceased physician or clients of a deceased attorney would seem to be "merely conjectural" unless a formal written demand for payment on some alleged negligence was received before death (Prob C §19050(a)) or within the 4-month claims period following first publication.

NOTE: Credit collection bureaus operate on assignment of accounts receivable. Therefore, the collection agency stands in the shoes of the creditor. Notice to the creditor at its last known address is binding on assignees. If this were not the case, creditors could keep the filing period open by an endless parade of assignees. It is the creditor's duty to be diligent. See *Gertner v Superior Court* (1993) 20 CA4th 927, 25 CR2d 47.

Under Prob C §19054, the trustee does not have to give notice to a known creditor if (1) the creditor has filed a claim under the trust claims procedure or (2) the creditor has demanded payment and the trustee elects to treat the demand as a claim. On the prescribed method of notice, see §10.40. On the time for notice, see §10.41.

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§10.40 2. Method of Notice

Notice to known or reasonably ascertainable creditors under Prob C §19052 (see §10.39) must be given as provided in Prob C §1215 (*i.e.,* by mail or personal delivery). Notice is generally mailed and is complete on the date of deposit in the U.S. mail. There is no requirement for delivery by certified mail. Indeed, the return of a certified letter by the postal service due to failure to deliver would put the trustee on notice that the creditor was not notified.

The duty to mail notice is different from having to ascertain the most correct address. It is sufficient to mail the notice to an address known to be that of the potential creditor, even if, *e.g.,* it is a "lock-box" operation far away from a business's corporate headquarters. The duty is to send out the notice, not to ensure that the creditor gets it in a timely manner. It is up to a creditor to provide an accurate address and to have efficient intracompany mail. In *Gertner v Superior Court* (1993) 20 CA4th 927, 932, 25 CR2d 47, the court held that, because the executor of the estate claimed he had mailed notice of administration to the creditor (VW Credit) at the address it had provided to the decedent (a payment address), and the creditor acknowledged receiving the notice, which it then forwarded to its legal department, the creditor's failure to file a timely claim was fatal. Although *Gertner* was a formal probate case, the same result should apply to trusts, which are governed by almost identical statutes.

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Source: Estate Planning/California Trust Administration/10 Creditors' Rights Against the Trust/§10.41 3. Time Requirements for Notice

§10.41 3. Time Requirements for Notice

Notice by mail or personal delivery must be given to known or reasonably ascertainable creditors (see §10.40) before expiration of the later of the following times (Prob C §19051):

- 30 days after the trustee first has knowledge of the creditor; or
- 4 months after the first publication of notice to creditors.

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§10.42 4. Liability of Trustee for Failure to Give Notice

If a creditor seeks a personal liability judgment against a trustee using the trust claims procedure who fails to give notice to the creditor under Prob C §19052, the creditor must (Prob C §19053(b)):

- Prove that the failure to send out the notice was in bad faith;
- Prove that the creditor did not have actual knowledge of the administration before 1 year after publication of notice to creditors, and payment would have been made if the claim had been properly filed; and
- File, within 16 months after first publication of notice, a petition to determine the liability of the trustee and serve the trustee with a notice of the hearing and a copy of the petition within 30 days of the hearing, as required by CCP §§413.10-417.40.

The trustee is not personally liable to the extent the claim is or could be paid out of the trust estate under a petition to file a late claim. Prob C §19053(c). For liability of a transferee when the claims procedure is used, see §10.33.

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§10.43 5. Dealing With Debts That Are Contingent, Disputed, or Not Yet Due

Probate Code §19000(a) refers to claims due, not due, or contingent, yet omits specific provisions for dealing with them such as those found in Prob C §§11460-11467 applicable in a probate proceeding. A trustee facing claims that are contingent or not yet due should petition the court under Prob C §17200 for authorization to use similar procedures to those prescribed for formal probate administration to avoid possible distributee liability under Prob C §19401. See §10.33.

NOTE: Probate Code §11420, which deals with the priority of debts, costs of administration, and other charges, is specifically incorporated into the trust claims law by reference in Prob C §19001(b). However, the rest of Prob C §§11400-11467 are not incorporated by reference.

Possible claims can include a secured obligation for which there may be recourse against property in the estate, other than the property that is the security, if the security is insufficient. A claim form filing is also required for a debt that is "not due" if such obligation will become due on the passage of time, such as a debt payable in installments. Prob C §19000(a). The same laws also consider claims that are not yet liquidated (*e.g.,* a tort action) to be subject to the claim filing rules.

PRACTICE TIP: Because the constitutional requirement of actual notice extends only to known or reasonably ascertainable creditors, a speedy closing should bar the "potentially ascertainable." Because it is theoretically possible to close an estate within 6 months, the handling of a decedent's affairs through formal probate administration rather than by the trust claims procedure may be useful in certain cases. Probate claims by creditors who are not reasonably ascertainable are cut off by final distribution, but trust claims may be made for 1 year after the first publication of notice to creditors. See §10.45.

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D. Filing Claims

§10.44 1. Time Limits for Filing Claims

A creditor must file a claim (Prob C §19100) before expiration of the later of:

- 4 months after the first publication of notice to creditors; or
- 60 days after the date actual notice is mailed or personally delivered to the creditor, if notice is given within the time provided in Prob C §19040(b).

Because a security interest is an existing property right of the creditor, the secured creditor can proceed against the security and not bother with a claim. Only the expenses of administration that are reasonably related to the property subject to a security interest have priority over the secured claim. Prob C §11420. A secured creditor's failure to file a claim will bar recovery for such additional items as attorney fees or collection costs that exceed the value of the security. If the creditor does not file or present the claim, he or she must look only to the security for payment, because Prob C §19302(b) requires the filing of a claim for enforcing a deficiency against other property of the estate. Of course, if the secured obligation is classified as a purchase money mortgage as defined in CCP §580b, the borrower has no personal liability and a creditor's claim would be a useless filing. On filing late claims, see §10.45.

NOTE: Even if a claim is later established in whole or in part, property distributed under the terms of the trust after an order settling claims and payments otherwise properly made before a claim is filed are not subject to the claim. However, a person who receives a preliminary distribution may be liable for restoration to the trust. Prob C §19103(d).

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§10.45 2. When Late Claim May Be Filed

Late filing may be allowed under Prob C §19103 if either of the following conditions is satisfied:

- The creditor did not receive timely notice of the proceeding; and
- The petition to file a late claim was filed within 60 days after the creditor had actual knowledge of the administration of the trust; or
- The creditor did not have knowledge of the facts giving rise to the claim's existence more than 30 days before expiration of the time provided in Prob C §19100; and
- The petition was filed within 60 days after the creditor had actual knowledge of both the administration of the trust and the facts giving rise to the claim's existence.

A creditor who has been sent timely notice will not normally be permitted to obtain relief through the filing of a petition to allow filing of a late claim; lack of diligence on the part of a creditor sent actual notice is no excuse. *Gertner v Superior Court* (1993) 20 CA4th 927, 932, 25 CR2d 47. See §10.39.

A petition to file a late claim may not be granted more than 1 year after the first publication of notice to creditors, and nothing in the statute authorizes allowance or approval of a claim barred by, or extends the time provided in, CCP §366.2 (see §10.11). Prob C §19103(b). Trusts are generally exempt from late claims that the trustee learns about more than 1 year from the earliest publication date of the notice. Prob C §19053(b)(2).

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§10.46 3. Preparation, Filing, and Service of Claim

The creditor must substantially comply with the procedural requirements for the preparation, filing, and service of the claim. See §§10.47-10.49. A claim should be as complete as possible, because the trustee can claim good faith in the rejection of an ill-defined claim.

PRACTICE TIP: Local rules should be consulted before submitting a claim for funeral expenses, especially one from the trustee. Some counties impose special requirements. See, *e.g.*, Contra Costa Prob Pol Man 401 (obligations arising after death except "reasonable" funeral expenses are administration expenses, not creditor's claims; requests for reimbursement by person who paid what might otherwise have been creditor's claim are claims for equitable subrogation and may be included for approval in account); San Mateo Ct R 4.37 (payments to personal representative as reimbursement for payment of funeral expenses shall be reported to court in same manner as an administrative expense).

The attorney for the trustee should not offer to help creditors complete claim forms. It may be appropriate, however, for the attorney for the trustee to advise the personal representative or family members who advanced funds for the funeral and related expenses that they need to present a timely claim. A claim for reimbursement of funeral expenses, unlike any other postmortem expenditures, must be filed in a timely manner. See Prob C §19000(a)(3). Funeral expenses can include anything that is reasonable or customary, such as food and drink for a wake or shiva, flowers, organist, and clergy. Generally, any deduction for funeral and related costs that would be allowed as a deduction on Schedule J of IRS Form 706 (federal estate tax return) under IRC §2053(a) should be an allowable item. See §12.41.

NOTE: If a creditor makes a written demand for payment within the time specified in Prob C §19100 (see §10.44), the trustee may waive formal defects and elect to treat the demand as a claim that is filed and established under the claims form procedure statutes by paying the amount demanded. Prob C §19154(a).

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§10.47 a. Form of Claim

The Judicial Council Form DE-172 (Creditor's Claim) (Probate), while not prescribed by law for trust claims, can be used for trust claims, although some court clerks might object that a "pleading" form is required under Cal Rules of Ct 2.100-2.119. Nevertheless, the probate creditor's claim form has a place for all of the information required by the Trust Law statute. See Prob C §§19150-19154.

NOTE: Probate Code §19153 provides that the Judicial Council may adopt a claim form, but none has yet been adopted under this provision.

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§10.48 b. Contents of Claim

A claim must be "supported by an affidavit" under Prob C §19151. The Judicial Council probate claim form contains a declaration under penalty of perjury that satisfies this requirement. Lack of formality does not invalidate a claim as long as the relevant information is timely presented and is verified by a declaration under penalty of perjury or an affidavit sworn to before an officer authorized to administer oaths, *e.g.,* a notary public.

The affidavit must state (Prob C §19151(a)):

- That the claim is just;
- If the claim is due, the facts supporting the claim, the amount of the claim, and that all payments on and offsets to the claim have been credited;
- If the claim is not due or contingent or the amount is not yet ascertainable, the facts supporting the claim; and
- If the affidavit is made by a person other than the creditor, the reason it is not made by the creditor.

PRACTICE TIP: A bill, in and of itself, is not sufficient if it is not verified or accompanied by an affidavit. However, the receipt of such a bill puts the trustee on notice and a notice to creditors must be sent to the potential creditor so that the potential creditor is advised of the procedures, including the procedures for petitioning to allow filing a late claim.

NOTE: The trustee may require satisfactory vouchers or proof to be produced to support the claim. An original voucher may be withdrawn after a copy is provided. If a copy is provided, the copy must be attached to the claim. Prob C §19151(b).

In addition to the information required in the affidavit supporting the claim, if a claim is based on a written instrument, either the original or a copy of the original with all endorsements must be attached to the claim. If a copy is attached, the original instrument must be shown to the trustee on demand unless it is lost or destroyed, in which case the fact that it is lost or destroyed must be stated in the claim. Prob C §19152(a). If the claim or a part of the claim is secured by a mortgage, deed of trust, or other lien recorded in the office of the recorder of the county in which the property subject to the lien is located, it is sufficient to describe the instrument and the recording reference for the instrument that created the mortgage, deed of trust, or other lien. Prob C §19152(b).

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Source: Estate Planning/California Trust Administration/10 Creditors' Rights Against the Trust/§10.49 c. Filing and Service of Claim

§10.49 c. Filing and Service of Claim

Probate Code §19150 provides that:

- A claim may be filed by the creditor or a person acting on behalf of the creditor.
- A claim shall be filed with the court and a copy shall be mailed to the trustee. Failure to mail a copy to the trustee does not invalidate a properly filed claim, but any loss that results from the failure shall be borne by the creditor.

Even though failure to mail a copy to the trustee does not invalidate a properly filed claim, it is recommended that a copy be mailed to the trustee. If there are multiple fiduciaries, a copy should be served on each one (or on each one's counsel if counsel's addresses are shown on the notices to creditors).

NOTE: The requirements for service of a claim on an estate's personal representative are stricter. Probate Code §9150(d) specifies that, if the claim is not both filed with the clerk and served on the personal representative, the claim is invalid.

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§10.50 4. Amendment or Revision of Claims

A creditor may amend or revise a claim and file it in the same manner as the claim. Prob C §19104(a). The amendment or revision, however, under Prob C §19104(b):

- May not increase the amount of the claim after the normal time for filing a claim has expired; and
- No amendment or revision may be made for any purpose after the earlier of:
- 1 year after the date of first publication of notice to creditors; or
- The time the court issues an order approving settlement of the claim, which may result in a period shorter than 1 year.

NOTE: An amendment or revision to specify the amount of a claim that, at the time of filing, was not due, was contingent, or was not yet ascertainable is not an increase in the amount of the claim within the meaning of Prob C §19104(b).

When an obligation, such as a promissory note, includes a stated rate of interest or provision for attorney fees, the claim should list all of these terms, such as "interest accruing at 8% per annum, compounded monthly," so that the claim amount increases automatically under its terms. This does not increase the amount of the claim because all the terms are presented in the original filing.

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E. Allowance and Rejection of Claims

§10.51 1. Filing and Notice of Allowance or Rejection

The trustee may allow or reject a claim in whole or in part. Prob C §19250. The trustee must file the allowance or rejection with the court clerk and give notice to the claimant, together with a copy of the allowance or rejection, as provided in Prob C §1215 (*i.e.,* by mail or personal delivery). Prob C §19251(a). See §10.52. On procedural challenges to late-filed claims, see §10.53.

The allowance or rejection must contain the total amount of the claim, and the amount allowed or rejected by the trustee, and a statement that the claimant has 90 days from the time the notice is given, or 90 days after the claim becomes due, whichever is later, to bring an action on a claim rejected in whole or in part. Prob C §19251(b). See §10.59.

Alternatively, the trustee may pay the claim or a portion of the claim and payment constitutes acceptance of the claim to the extent of the payment. Prob C §19252.

The trustee may not allow a claim that is barred by the statute of limitations. Prob C §19253(a). However, the filing of a claim tolls the statute of limitations until the trustee gives notice of allowance or rejection (Prob C §19253(b)), and the allowance of a claim further tolls the statute of limitations as to the part of the claim allowed until the allowed portion of the claim is paid (Prob C §19253(c)).

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§10.52 2. Form of Notice of Allowance or Rejection

The Judicial Council Form DE-174 (Allowance or Rejection of Creditor's Claim) (Probate), while not prescribed by law for trust claims, can be used for trust claims and has a place for all of the information required by the Trust Law. See §10.51.

NOTE: Probate Code §19251(c) provides that the Judicial Council may adopt an allowance or rejection form, but none has yet been adopted under this provision.

These requirements do not apply to a written demand for payment that the trustee elects to treat as a claim under Prob C §19154. Prob C §19251(d). See §10.46.

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§10.53 3. Procedural Challenges to Late-Filed Claims

There is some confusion among attorneys and courts regarding the interplay between the 1-year statute of limitations (CCP §366.2) and what happens when a claim is rejected because it is filed late. The 1-year period of CCP §366.2 is the outside limit, barring tolling by use of the trust claims procedure (see §10.11) or exceptions such as equitable estoppel (see §10.15).

If a creditor files late (more than 4 months after first publication of notice to creditors or 60 days after actual notice) without first petitioning the court for permission as required under Prob C §19103, the trustee should reject the claim. Acceptance of such a procedurally deficient claim would be a breach of fiduciary duty (unless all beneficiaries are competent adults and consent to the trustee's proposal to pay such a claim, *e.g.*, a relatively modest charge from the family physician). Note further that a petition to file a late claim does not extend the 1-year time period specified in CCP §366.2. Prob C §19103(b). See §10.45.

There is no authority to file a demurrer to a claim. The trustee must reject the claim, and it is then up to the creditor to commence legal proceedings within the time allowed (90 days from rejection under Prob C §19255(a)) or the claim will be lost forever. See §10.59.

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F. Court Approval and Settlement of Claims

§10.54 1. Petition for Approval and Settlement of Claims

If the trust claims procedure is used, the trustee or a beneficiary (but not a creditor) may file a petition with the court for allowance, settlement, or compromise of submitted claims that have not been rejected by the trustee and for which trust property may be liable. The trustee or beneficiary may file the petition at any time after the filing and first publication of notice and after expiration of the time to file claims. Prob C §19020(a). Alternatively, the petition may seek an allocation of any amounts due to two or more trusts that may be liable for the claims. Prob C §19020(b).

The petition must be filed in the proper county as determined under the provisions of Prob C §19003 (see §10.35). Prob C §19021. The petition must be verified and contain specified information as provided in Prob C §19022. Notice of the petition must be served on creditors and other interested parties under Prob C §§19023-19024. See §10.55. A form of petition is provided in §10.56.

For court action on the petition, see §10.57. A form of order for approval and settlement of claims is provided in §10.58.

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§10.55 2. Service of Notice and Copy of Petition

As is the case for other trust matters, at least 30 days before the hearing date, the petitioner must serve notice and a copy of the petition for approval and settlement of claims on the following interested persons:

- Each creditor whose interests in the trust estate might be affected by the petition (Prob C §19023);
- All trustees of the trust for which the petition is filed (Prob C §19024(a));
- All trustees of other trusts that might be subject to an allocation of liability (see discussion of spousal apportionment in §10.31) (Prob C §19024(a));
- All affected beneficiaries (Prob C §19024(b));
- The personal representative of the settlor's estate (if known) (Prob C §19024(c)); and
- The California Attorney General if a charitable trust is involved (Prob C §19024(d)).

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Source: Estate Planning/California Trust Administration/10 Creditors' Rights Against the Trust/§10.56 3. Form: Petition for Approval and Settlement of Claims

§10.56 3. Form: Petition for Approval and Settlement of Claims

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SUPERIOR COURT OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In re the _ _[*name of trust*]_ _
Trust created _ _[*date*]_ _ by
_ _[*name*]_ _, Decedent.

Case No. _ _ _ _ _ _

PETITION FOR APPROVAL AND SETTLEMENT OF CLAIMS
(PROB C §19020)
Hearing: _ _[*date*]_ _
Time: _ _[*time*]_ _
Dep't: _ _[*number*]_ _

Petitioner, _ _[*name of trustee*]_ _, alleges:

1. On _ _[*date*]_ _, _ _[*name of settlor*]_ _ established a Trust, for which _ _[*name of trustee*]_ _ was to be Successor Trustee after the death of _ _[*name of settlor*]_ _. _ _[*Name of settlor*]_ _ died on _ _[*date*]_ _. Therefore, _ _[*name of trustee*]_ _ is now the sole Trustee of the Trust of _ _[*name of settlor*]_ _.

2. The Successor Trustee has made a diligent search for all known and reasonably ascertainable creditors. The statutory form of the Notice to Creditors under Probate Code §19040 was filed on _ _[*date*]_ _. The Notice to Creditors was duly published, commencing as of _ _[*date*]_ _, and an affidavit of publication is on file in this matter. A copy of the Notice to Creditors prepared under Probate Code §19052 was mailed on _ _[*date*]_ _ to each of the known and reasonably ascertainable creditors. Notice was filed with this Court on _ _[*date*]_ _.

3. Probate Code §19100 provides that a creditor's claim must be filed within the later of 4 months from first publication or 60 days from service of the notice on the creditor. The time in which to file a valid claim has now expired for all known and reasonably ascertainable creditors. Below are listed the names of creditors, the date the Notice to Creditors was mailed, the date the creditor's claim was filed, the amount of such claim, and the amount of such claim accepted by the Trustee.

Creditor	Date Notice Mailed	Date Claim Filed	Amount of Claim	Amount of Claim Accepted
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____

4. Probate Code §19020 authorizes the Trustee to petition the Court to approve the acceptance of claims.

5. _ _[*No one has/The following have*]_ _ filed request(s) for special notice _ _[*: List names and addresses, if any*]_ _.

WHEREFORE, Petitioner requests that the Court order:

1. That the amount of claims be accepted as proposed above;

2. That such further order be made as the Court considers just and proper.

Date: _ _ _ _ _ _ __[*Signature of trustee*]__
_ _[*Typed name*]_ _**, Trustee**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

VERIFICATION

I, _ _[*name of trustee*]_ _**, am the Petitioner in the above-entitled proceeding. I have read the foregoing petition and all attachments to it and know the contents of it. These contents are true of my own knowledge. I declare under penalty of perjury that the foregoing is true and correct and that this declaration was executed under the laws of the State of California on** _ _[*date*]_ _**, at** _ _ _ _ _ _**, California.**

Date: _ _ _ _ _ _ __[*Signature of trustee*]__
_ _[*Typed name*]_ _

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§10.57 4. Court Action on Petition for Approval and Settlement of Claims

The court may rule on the petition for approval or settlement of claims even if a creditor, beneficiary, or trustee who receives notice does not file a timely written pleading in response to the notice of hearing. The court may rule on the petition based on the petition and written statements filed by the time of the hearing. The nonresponsive creditor, beneficiary, or trustee may not participate further in the proceeding but will be bound by the court's ruling. Prob C §19025.

The court may dismiss a petition if it appears that the proceeding is not reasonably necessary to protect the interests of the trustee or any beneficiary of the trust. Prob C §19026. The court may make any orders and take any other action necessary or proper to dispose of the matters presented by the petition. Prob C §19027(a). If the court determines that the assets of the trust estate are insufficient to pay all debts, the court must order payment under the provisions for priority of payment of debts set forth in Prob C §11420. Prob C §19027(b).

For form of order, see §10.58.

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§10.58 5. Form: Order for Approval and Settlement of Claims

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SUPERIOR COURT OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In re the _ _[*name of trust*]_ _
Trust created _ _[*date*]_ _ by
_ _[*name*]_ _, Decedent.

Case No. _ _ _ _ _ _

ORDER OF APPROVAL AND SETTLEMENT OF CLAIMS (PROB C §19020)

The Petition for Approval and Settlement of Claims of _ _[*name of trustee*]_ _, Trustee of the Trust of _ _[*name of settlor*]_ _ came on for hearing on _ _[*date*]_ _. The Court finds that notice of the hearing on the Petition has been given as required by law and further finds as follows:

1. The statutory form of the Notice to Creditors under Probate Code §19040 was filed on _ _[*date*]_ _. The Notice was duly published, commencing as of _ _[*date*]_ _, and an affidavit of publication is on file in this matter.

2. On _ _[*date*]_ _, the Notice to Creditors was mailed to all known creditors in compliance with Probate Code §19050, and such Notice was subsequently filed with the Court on _ _[*date*]_ _. On _ _[*date*]_ _, the time for filing claims expired. On _ _[*date*]_ _, the Petition for Approval and Settlement of Claims was filed and all known creditors were duly noticed.

3. The creditors listed below have filed timely claims in accordance with Probate Code §19100. Therefore, _ _[*name*]_ _, the Trustee, is directed to make payment as set forth below:

LIST OF APPROVED CLAIMS

[*Add if some creditors have been paid*]

4. The claim filed by _ _[*name of creditor*]_ _ has been paid in its entirety based on a Settlement Agreement between the parties, and _ _[*name of creditor*]_ _ has filed a Satisfaction and Release of Claim in these proceedings.

[*Continue*]

WHEREFORE, the Court orders that:

1. The creditors listed in paragraph three (3) above be paid as set forth in such paragraph:

[*Add if some creditors have been paid*]

2. The claim filed by _ _[*name of creditor*]_ _ has been satisfied.

[*Continue*]

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the _ _[*title of court*]_ _

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G. Action on Rejected Claim

§10.59 1. Filing Action on Rejected Claim

A timely filed claim rejected under the trust claims procedure is barred unless the creditor files a lawsuit or the matter is referred to a referee or to arbitration within the following time limits (Prob C §19255(a)):

- 90 days after giving notice of rejection of the claim, if the claim is due at the time of giving notice; or
- 90 days after the claim becomes due, if the claim is not due at the time of giving notice.

In addition to other venues, suit may be brought in the county in which the principal office for the administration of the trust is located. Prob C §19255(b).

NOTE: If the trustee has not acted within 30 days after the claim is filed, the creditor may elect to treat the claim as rejected on the 30th day. Prob C §19254. However, the creditor need not act on the claim after 30 days: If the trustee has not rejected the claim, the creditor can wait until the claim is acted on in the ordinary course of trust administration.

Notice of pendency of the action or referral to a referee or arbitrator must be filed in the trust proceeding, together with proof of service of the notice to the trustee. Prob C §19255(c). Failure to file such a notice relieves the trustee and beneficiaries of personal liability for trust distributions. Prob C §19255(d). A form of notice of pendency of action is provided in §10.60.

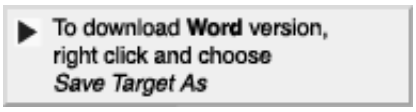
NOTE: Under Prob C §19255(c), personal service of a copy of the summons and complaint on the trustee is equivalent to filing and giving notice. However, the converse is not true. Filing the notice is no substitute for service of the summons and complaint.

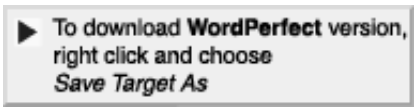
If the rejected claim was filed late, it is likely that the trustee-defendant would file a demurrer to the complaint (CCP §§430.10-430.90) based on the expiration of the time in which the creditor should have filed a claim. See §10.53. The trustee should request judicial notice under CCP §430.70 of the documents in the court file to establish the date on which the proof of notice to creditors was filed and the expiration of the statutory period in which a claim should have been filed. On the other hand, if the claim was filed more than 1 year from date of death, the demurrer to a complaint on the rejected claim should be based on CCP §366.2.

A form of complaint is provided in §10.61. On the form of a judgment for the plaintiff on a rejected claim, see §10.62. On costs to the prevailing party, see §10.63.

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§10.60 2. Form: Notice of Pendency of Action





[*Title of court*]

[*Title of case*] **Case No. _ _ _ _ _ _ _**

NOTICE OF PENDENCY OF ACTION (PROB C §19255)

NOTICE IS HEREBY GIVEN that an action titled _ _[*full title of action*]**_ _ has been filed in _ _**[*title of court*]**_ _, bearing No. _ _ _ _ on _ _**[*date*]**_ _, and that the nature of that action is _ _**[*describe generally, e.g., for goods sold and delivered*]**_ _.**

Dated: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for Petitioner

Copies: Original to be signed and filed in trust proceeding; one copy to be sent to the attorney for the trustee; office copies.

Comment: The statute does not state what the notice must contain. It would appear to be sufficient to set forth the title of the action, where it is filed, its number, the nature of the action, and the signature of the creditor's attorney.

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§10.61 3. Form: Complaint Against Trustee

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_ _[*Name(s)*]_ _,
Plaintiff(s)

vs

_ _[*Name(s)*]_ _, **as Trustee(s) of the Trust of** _ _[*name of settlor*]_ _,
Defendant(s)

Case No. _ _ _ _ _ _

TITLE OF COMPLAINT
Hearing: _ _[*date; time*]_ _
Dep't: _ _[*number*]_ _
Hearing judge: _ _[*if known*]_ _
Action filed: _ _[*date*]_ _
Trial date: _ _[*if set*]_ _

Plaintiff, _ _[*name of creditor*]_ _**, alleges:**

1. _ _[*Name of trustee*]_ _ **is the Trustee of the Trust of** _ _[*name of settlor*]_ _**, deceased, who died on** _ _[*date*]_ _**.**

2. On _ _[*date*]_ _**, within the time allowed by law, Plaintiff presented a written claim, verified and in due form, setting forth the matters on which this action is based, to** _ _[*name of trustee*]_ _**, as Trustee of the Trust of** _ _[*name of settlor*]_ _**, deceased, hereafter referred to as the Trustee.**

[*Add if copy of claim is attached as exhibit*]

3. A copy of the claim so presented is attached, marked Exhibit _ _**, and is referred to and made a part of this complaint as fully as if it were set out at length.**

[*Continue*]

[*Alternative 1: Claim was actually rejected*]

[4.] On or about _ _[*date*]_ _**, the claim was rejected in writing by the Trustee.**

[*Alternative 2: Time to reject has elapsed without action by the trustee*]

[4.] More than 30 days have elapsed since the claim was presented, as alleged above, and the Trustee has failed to take any action on it. Plaintiff hereby elects to treat the claim as rejected by the Trustee.

[*Continue*]

[5.] No part of the sum of $_ _[*amount*]_ _ **set forth in the claim has been paid by** _ _[*name of settlor*]_ _**, deceased, the Trustee, or any other person.**

WHEREFORE, Plaintiff requests judgment against the defendant, _ _[*name of trustee*]_ _**, as Trustee of the Trust of** _ _[*name of settlor*]_ _**, deceased, for payment of the sum of $**_ _[*amount*]_ _ **and for costs of suit, to be paid out of the Trust in due course of administration.**

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Plaintiff

Copies: Original to trustee; copy to file with court clerk; office copies.

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§10.62 4. Judgment on Rejected Claim

A judgment for plaintiff in an action on a rejected claim should provide that the recovery be paid "out of the trust in due course of administration." Prob C §19301. See §10.9. The successful judgment creditor will not be able to levy on trust assets except in very limited circumstances. See Prob C §§19300-19304, discussed in §10.8.

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§10.63 5. Costs to Prevailing Party

The prevailing party is entitled to court costs and, if the court determines that the prosecution or defense of the action against the prevailing party was unreasonable, the prevailing party is entitled to reasonable litigation expenses, including attorney fees. The prevailing party is the trustee if the creditor recovers an amount equal to or less than the amount of the claim allowed by the trustee, and is the creditor if the creditor recovers an amount greater than the amount of the claim allowed by the trustee. Prob C §19255(e).

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10A

Creditors' Rights Against Trust Beneficiary's Interest

Michael Patiky Miller
Margaret M. Hand

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I. INVOLUNTARY TRANSFERS OF BENEFICIARY'S INTEREST

§10A.1 A. Enforceable Restrictions

The common law long recognized that a trust settlor can restrict the use of the assets by third party beneficiaries, such as the settlor's irresponsible offspring. These restrictive clauses or trusts are commonly called "spendthrift" clauses or trusts. See *Canfield v Security First Nat'l Bank* (1935) 8 CA2d 277, 48 P2d 133.

If the trust instrument contains a spendthrift clause, or the trust is one for education or support, the beneficiary's interest in income (Prob C §15300) or principal (Prob C §15301) may not be transferred and is not subject to enforcement of a money judgment until such time as a distribution is paid to the beneficiary. Prob C §15302. See §10A.2. Neither can a transferee or creditor of the beneficiary compel the trustee to make discretionary distributions to the beneficiary. Prob C §15303. See §10A.3. Of course, these restrictions do not apply to creditors of the settlor as a beneficiary of the trust. Prob C §15304. See §10.3. However, Prob C §§15300-15309 provide a number of important exceptions to the enforceability of these transfer restrictions, see §§10A.4-10A.8. Payments to creditors under these exceptions may prevent distributions to other beneficiaries. See §10A.9. These transfer restrictions do not apply to taxing authorities (see §10A.10) but they may be respected in bankruptcy (see §10A.11).

On enforcement of a money judgment against the beneficiary's interest, see §§10A.12-10A.16. On voluntary transfers, see §§10A.17-10A.29. On holders of appointment powers, see §§10A.30-10A.33. On remainder beneficiaries, see §10A.34.

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§10A.2 1. Trusts for Education or Support: Prob C §15302

Payments required for the beneficiary's support or education, or both, have a privileged status under Prob C §15302. To the extent that the payments are in fact necessary for the beneficiary's education or support, they may not be transferred and are not subject to the enforcement of a money judgment until paid. In effect, a spendthrift clause is implied in a trust for support or education, even if it is not there. The effect of the implied clause is similar to the effect of an express clause under Prob C §15307, but not under Prob C §15306.5. Under Prob C §15302, amounts necessary for "education or support" of a beneficiary are protected, while Prob C §15306.5 (which qualifies the restraints under Prob C §§15300-15301) protects amounts necessary "for the support of the beneficiary and all the persons the beneficiary is required to support." Prob C §15306.5(c).

The beneficiary's executor may be able to compel payment of the beneficiary's last-illness and funeral expenses from a support trust. See *Elliott v Superior Court* (1968) 265 CA2d 825, 71 CR 807. There is no authority regarding whether the providers of these services can seek repayment directly from the trust.

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§10A.3 2. Discretionary Distributions: Prob C §15303

Even in the absence of a spendthrift provision, no transferee of a right to receive payments may compel the trustee to pay any amount that may be paid only in the trustee's discretion. In other words, a transferee cannot force the trustee to exercise the trustee's discretion, whether or not the trust provides a standard for the exercise of the discretion. Prob C §15303(a), (c). In *Young v McCoy* (2007) 147 CA4th 1078, 54 CR3d 847, the court held that the trustee of a discretionary support trust did not abuse her discretion in determining that no distributions should be made to a beneficiary who was serving a life sentence for attempted murder. The trustee explained that she did not deem any payments to be necessary because the State of California was providing for the beneficiary's needs in prison. Therefore, the court could not compel distributions at the request of the beneficiary's victim, who was seeking to enforce a judgment awarding personal injury damages.

However, if the trustee pays any discretionary amount to the beneficiary after learning of a transfer of the beneficiary's interest or being served by process in a judgment creditor's action under CCP §709.010 (see §10A.12), the trustee will be liable to the transferee or creditor to the extent that the payment impairs the right of the transferee or creditor. Prob C §15303(b). If, for example, the trustee plans to distribute $500 to the beneficiary but before doing so learns of a creditor's attempt to seek an order under CCP §709.010 compelling distribution of $300 to the creditor, the trustee may nevertheless distribute $200 to the beneficiary, because the distribution would not impair the creditor's rights.

By contrast, the trustee is not liable for making distributions to the beneficiary, even with knowledge of the claim of a transferee or creditor, if the trust instrument contains an express restraint on voluntary or involuntary transfer valid under Prob C §15300 or §15301. Prob C §15303(b). Note that this exception does not apply to the implied spendthrift provision of Prob C §15302, which deals with education or support trusts. The trustee, however, must not impair the rights of the creditor or transferee even though the beneficiary's interest is protected by statute from voluntary or involuntary transfer to the extent necessary for the beneficiary's education and support. The trustee who knows of a transfer or who has been served with process in a CCP §709.010 proceeding would be at risk in making a distribution under those circumstances. Until this provision is clarified by the courts, the trustee faced with this problem should petition for instructions under Prob C §17200(b)(6).

The creditor of a deceased beneficiary of a discretionary interest apparently has no rights against the trust corpus. The trust instrument may give the trustee discretion to make these payments.

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§10A.4 B. Exceptions to Enforceability of Transfer Restrictions

Probate Code §§15300-15309 provide a number of important exceptions to the general concept that a settlor can protect his or her beneficiary's trust from attack by parties to whom such beneficiary owes some duty of support or other responsibility:

- Prob C §15301(b) (principal amounts that have become due and payable; judgment creditor can use CCP §709.010). See §10A.12.
- Prob C §15305 (claims for child support). See §10A.5.
- Prob C §15305.5 (restitution judgment for the commission or conviction of a felony). See discussion regarding judicial process in §§10A.12-10A.16.
- Prob C §15306 (claims for reimbursement for public support). See §10A.6.
- Prob C §15306.5 (right of a general creditor to reach up to 25 percent of payments due to a beneficiary). See §10A.7.
- Prob C §15307 (claims of judgment creditors to amount in excess of that needed for beneficiary's education and support). See §10A.8.

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§10A.5 1. Claims for Child or Spousal Support: Prob C §15305

The restrictions on transfer recognized in Prob C §§15300-15301 do not prevent a court's reaching a beneficiary's interest for the support of a spouse, registered domestic partner, or minor child under a support judgment. Prob C §15305; Fam C §297.5. If payments of income or principal are fixed by the terms of the trust (*i.e.,* not subject to the trustee's discretion), the court may order the trustee to satisfy all or part of the judgment from all or part of those trust payments as they become due and payable. Prob C §15305(b).

If payments from the trust are discretionary, the court may order support payments to be made "out of all or part of future payments that the trustee, pursuant to the exercise of the trustee's discretion, determines to make to or for the benefit of the beneficiary." Prob C §15305(c). These rules are intended to prevent the beneficiary from enjoying the benefits of the trust while neglecting to support dependents. In *Ventura County Dep't of Child Support Servs. v Brown* (2004) 117 CA4th 144, 11 CR3d 489, the court further held that a trustee of a spendthrift trust may be compelled to make distributions satisfying the beneficiary's child support obligations, despite trust provisions allowing the trustee to make no such distributions.

Probate Code §15305 gives the court discretion to apportion the payments between the beneficiary and those to whom he or she owes a support obligation. Thus, the court may order an amount less than the full support award to be paid from the trust. The remainder could come from other sources. The court acts, in a sense, as a trustee of a trust created for the benefit of the beneficiary and his or her dependents, sprinkling the payments among them in an equitable manner. See Comment to Prob C §15305.

The procedure for obtaining payments from the trustee is not clearly spelled out. Creditors of the settlor may file a petition under Prob C §850(a)(3)(C), but that method is not available to other creditors of the trust. Because Prob C §15305 is worded specifically in terms of a money judgment, it presumably was intended that the procedure described by CCP §709.010 would be used by creditors other than a settlor's creditor. See Prob C §15306. For a form to use in this procedure, see §10A.14.

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§10A.6 2. Liability for Public Support: Prob C §15306

Claims of state and local public agencies for reimbursement of public support of a trust beneficiary or the beneficiary's spouse, registered domestic partner, or minor child are made through a proceeding under CCP §709.010. Prob C §15306(a); Fam C §297.5. Three situations are contemplated:

- If the beneficiary has a right to compel payments, the court may order the trustee to satisfy the liability out of payments as they become due.
- Whether or not the beneficiary may compel payments, the court may order the trustee to satisfy the liability out of payments that will be made in the trustee's discretion.
- If the beneficiary has set up a trust for himself or herself or for a spouse, registered domestic partner, or minor child, the court may order the trustee to satisfy all or part of the liability to the extent that the trustee has a right to make payments.

There is one exception to the rule that trust assets can be reached: It does not apply to any trust established for the benefit of an individual who has a disability that substantially impairs the individual's ability to provide for his or her own care or custody and constitutes a substantial handicap. The exception does not apply, however, if the trust results in the individual being ineligible for needed public social services under Welf & I C §§10000-18996. Prob C §15306(b).

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§10A.7 3. Rights of General Creditors: Prob C §15306.5

General judgment creditors may reach a part of mandatory or discretionary payments to the beneficiary despite a spendthrift provision. Prob C §15306.5. The rules may be summarized as follows:

- The order may not require payments of amounts necessary for the support of the beneficiary or the persons the beneficiary is required to support.
- The order may not require payment of more than 25 percent of the amounts that would otherwise be paid to the beneficiary. Further, the aggregate of all orders, except support orders, may not exceed 25 percent of these amounts. A support judgment may exceed the 25-percent level.
- A payment under a support judgment (see §10A.5) or a judgment for reimbursement of public support (see §10A.6) will reduce the amount subject to a court order under Prob C §15306.5. If a support judgment equals or exceeds 25 percent of the distribution, nothing will be available for general judgment creditors.
- A support judgment has priority over any other judgment, regardless of which was first in time.

NOTE: No provision deals with priorities among general judgment creditors. While CCP §709.010 gives the judge discretion in ordering how the payments are to be made, there is no discretion regarding priorities.

Probate Code §15306.5 does not compel a trustee to exercise discretion in order to provide amounts to satisfy creditors. A trustee with discretion may alter the amount of payments or terminate payments entirely. This statute explicitly releases trustees from any obligation to oppose a petition by general creditors or claim any exemption on behalf of the beneficiary whose interest is sought to be affected. Prob C §15306.5(e). See §10A.8 for discussion of the treatment of any excess income or principal over the amounts needed for reasonable support and education under Prob C §15307.

The relationship between Prob C §§15306.5 and 15307 is not clear, because the former puts a strict limit of 25 percent on amounts available to general judgment creditors, whereas the latter reaches any amounts that the beneficiary is entitled to in excess of amounts needed for education and support. Former CC §859, on which Prob C §15307 is based, dealt only with rents and profits from real and personal property not directed to be accumulated. The California Law Revision Commission recommendation also refers to income, but §15307 as enacted is not so limited. See Comment to Prob C §15307. Judgment creditors should rely on §15307, while beneficiaries should argue that §15307 is subject to the limitations of Prob C §15306.5. The burden is on the creditor to prove the existence of any surplus income. *Estate of Lawrence* (1968) 267 CA2d 77, 83, 72 CR 851; *DiMaria v Bank of Cal*. (1965) 237 CA2d 254, 46 CR 924.

Whichever statute applies, the appropriate support level will have to be determined. The standard by which this is measured is the beneficiary's "station in life." Factors that the court may consider include the general cost of living in the community and the beneficiary's medical and other reasonably necessary expenses. See *Canfield v Security First Nat'l Bank* (1939) 13 C2d 1, 21, 87 P2d 830. Other factors are housing costs, the number of the beneficiary's dependents, and accustomed spending money. *Magner v Crooks* (1903) 139 C 640, 642, 73 P 585; *Estate of Setrakian* (1960) 178 CA2d 833, 3 CR 444. Automobile and travel expenses, other income, and debts may also be considered in determining the amounts needed for a beneficiary's support. *Smith v Smith* (1942) 51 CA2d 29, 124 P2d 117.

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§10A.8 4. Excess Over Amounts Required for Education and Support: Prob C §15307

Probate Code §15307 provides that all amounts to which the beneficiary is entitled or that the trustee has determined to pay to the beneficiary in excess of that needed for the beneficiary's support and education are subject to the claims of judgment creditors. In other words, a spendthrift clause is effective only with respect to the amount that is or will be necessary for these purposes.

In the case of a typical bypass trust providing for invasion of trust principal for the surviving spouse's health, education, and support, the entire amount of the payment determined by the trustee ordinarily should be exempt unless the court determines that the payment was not in fact needed by the spouse. Such trusts are often designed to allow the surviving spouse to have access to the trust assets without giving the spouse a general power of appointment that will cause inclusion of the trust in the spouse's estate under IRC §2041(b)(1)(A) if the spouse becomes the trustee. See §2.68. The result may depend on whether the trust document allows the trustee to consider the beneficiary's other resources. In *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639, the court held that the trustee of a bypass trust could consider the surviving spouse's assets in deciding whether to invade trust principal for the spouse's support. The court cited *Estate of Ferrall* (1953) 41 C2d 166, 176, 258 P2d 1009, for the proposition that the trustee should consider a beneficiary's other resources before making a distribution of principal unless the trust document shows another intent. If the trust had instructed the trustee not to consider the spouse's assets, a creditor of the spouse could have argued that the trustee was required to make distributions to the spouse that would then be subject to creditor claims because they were not in fact needed for the spouse's support.

In some situations, the entire payment from the trust may be necessary for the beneficiary's support, leaving no "surplus." See *Estate of Setrakian* (1960) 178 CA2d 833, 3 CR 444. The result could be that a judgment creditor of a beneficiary accustomed to a relatively high standard of living will receive less "surplus" than would a creditor of beneficiary with a lower living standard. See 3 Scott & Ascher on Trusts §15.2.1 (5th ed 2007). But the court may take the beneficiary's extravagances into account and determine that a lesser amount is all that is actually necessary. See *Canfield v Security First Nat'l Bank* (1939) 13 C2d 1, 21, 87 P2d 830.

Probate Code §15306.5 expressly gives the court the power to determine what is necessary support in making orders under that section. See §10A.7. The court would apparently make the same determination under §15307 also, although this power is not expressly given. The trustee's determination that a specific amount is necessary for the beneficiary's support may well be changed by the court's finding, on petition of a creditor, that the beneficiary needs a lesser amount, leaving a "surplus" to be paid to the creditor. See Scott & Ascher §15.3.1.

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§10A.9 C. Effect of Restraint Exceptions on Certain Distributions

Probate Code §§15303-15306 provide that judgment creditors are entitled to satisfy money judgments from payments that would be made either to the beneficiary or for the benefit of the beneficiary. Thus, if a trustee receives a beneficiary's hospital bill, and the trust directs the payment of medical expenses, the amount to be used for this purpose becomes subject to the claims of judgment creditors with the various limitations and exceptions in Prob C §§15303-15306. To the extent that this distribution is taken by creditors, the hospital bill remains unpaid. Every time the trustee attempts to make payment, a portion or all of the funds are diverted to the creditors. The creditors are eventually paid and the medical bill is paid. The distributions to creditors have in effect supplanted payments that would otherwise have gone to other beneficiaries of the trust who are entitled to take only to the extent that funds are not paid for the debtor beneficiary.

The same result occurs when a portion of support payments intended for a specified beneficiary is used to support his or her spouse, registered domestic partner, or children. To the extent that the debtor beneficiary does not receive the payments, that beneficiary still has support needs that are to be met from the trust. The other trust beneficiaries effectively support the ex-spouse, former domestic partner, or child of the debtor beneficiary, while the trust distributions to the debtor beneficiary are not reduced at all.

Because of the potential or actual detriment to the other beneficiaries, both present and future, a trustee faced with this situation is well advised to petition the court for instructions under Prob C §17200(b)(6).

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§10A.10 D. Taxing Authorities

The Internal Revenue Service can levy on all of a beneficiary's interest in a spendthrift trust, notwithstanding limitations in state law. See IRC §6331; *Leuschner v First W. Bank & Trust Co.* (9th Cir 1958) 261 F2d 705. The holding in *Leuschner* was based on the government's overriding interest in collecting taxes. The court specifically refused to speculate on what its position would have been if the trust had provided that, on an attempt to seize the beneficiary's interest, the trust income otherwise payable to the beneficiary would be payable to another party. 261 F2d at 708.

PRACTICE TIP: To avoid the potential for seizure from a support trust by the tax authorities, the settlor interested in preserving the trust estate should consider having a spendthrift trust drafted with more than one discretionary beneficiary, for example, the child who might need the protection and a wealthy sibling. Because a specific beneficiary's interest in the trust cannot be readily ascertained, this technique takes advantage of the issue left open in *Leuschner.*

California taxing authorities may seek a withholding order for taxes to collect a state tax liability under Rev & T C §18671 from periodic payments to a beneficiary. The state is limited by that section to 25 percent of payments due or coming due. It is not clear what happens if the state and a general creditor both claim 25-percent interests, or whether the sequence in which the levies are made matters. If this situation occurs, the trustee should petition for instructions.

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§10A.11 E. Effect of Bankruptcy

Federal bankruptcy cases have been more favorable to spendthrift trusts than have tax cases. The general rule in bankruptcy is that property that passes to the debtor (the petitioner in bankruptcy) by way of bequest, devise, or inheritance within 180 days of filing the petition becomes a nonexempt asset of the bankruptcy estate, *i.e.,* the property can be seized by the bankruptcy trustee for the benefit of creditors. 11 USC §541(a)(2)(5)(A). The federal courts have made it clear that such devise or other transfer must be unhindered by a spendthrift clause. For example, in *Zimmermann v Spencer (In re Spencer)* (CD Cal 2004) 306 BR 328, the debtor's mother died before the filing for bankruptcy and the father died within 180 days of the filing. Because the property was subject to a spendthrift restriction when the parents created the trust, the surviving parent's subsequent death within the 180-day "window" did not subject the trust to inclusion within the bankruptcy estate.

In *Birdsell v Coumbe (In re Coumbe)* (BAP 9th Cir 2003) 304 BR 378, however, the court held that monies distributed from a spendthrift trust to the bankruptcy debtor within 180 days after the petition was filed were included in the bankruptcy estate to the extent distributions were made from income. Reviewing case law, the court concluded that distributions of income from a testamentary trust (but not a formerly revocable trust) are included to the extent that distributions are made from trust income but not trust principal.

Note that the case law distinguishes between income distributions and principal distributions, but not between mandatory distributions and discretionary ones. Perhaps the early cases involved trusts that provided for mandatory distributions of income and discretionary distributions of principal. In any event, a prudent bankruptcy debtor may be well advised to avoid receiving any large distributions from a spendthrift trust within 180 days after the filing of a bankruptcy petition. This may provide protection even if the distribution is mandatory.

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II. ENFORCEMENT OF MONEY JUDGMENT AGAINST BENEFICIARY'S INTEREST

§10A.12 A. Creditor's Petition Under CCP §709.010(b)

Code of Civil Procedure §709.010 provides the exclusive procedure for enforcing a money judgment against the judgment debtor beneficiary's interest in a trust. CCP §709.010(b). This section affects all types of trusts, regardless of the existence of spendthrift language or the nature of the beneficiary's interest. It is subject to the limitations of Prob C §§15301-15307. CCP §709.010(c). See §10A.13.

It is not at all clear whether CCP §709.010(b) intends merely to designate which court the judgment creditor must use ("upon petition under this section by a judgment creditor to a court having jurisdiction over administration of the trust as prescribed in Part 5") or whether it also intends to designate the procedure that must be followed. If the former is the correct reading, no procedure is specified; if the latter is correct, the judgment creditor must petition the court for enforcement of the judgment using the procedures set out in Prob C §§17000-17457. For a sample form of petition, see §10A.14. On the effect of the petition, see §10A.15. For a sample order, see §10A.16.

There is a jurisdictional problem, however, in that a third party creditor does not appear to have standing to bring a petition under Prob C §17200. This is true whether the creditor seeks to obtain the surplus amount under Prob C §15306.5 (see §10A.7) or §15307 (see §10A.8), or to obtain the entire interest of the beneficiary when there is no spendthrift provision. CCP §709.010(c). In the author's opinion it seems logical that, although the pleading is called a "petition," the creditor should file it in the court that awarded the original judgment.

The trustee has no duty to oppose the creditor's CCP §709.010 petition to satisfy a money judgment or make any claim for exemption on behalf of the beneficiary. Prob C §15306.5(e). Further, the trustee is not liable for any action taken, or not taken, in compliance with any court order made under §15306.5. Prob C §15306.5(e). The trustee may consider opposing the petition on behalf of the beneficiary whose interest is in jeopardy if the trustee has valid grounds for objection. Alternatively, the trustee can seek instructions under Prob C §17200(b)(6), or the trustee can take no action at all.

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§10A.13 B. Relationship of Prob C §15301 and Petition Under CCP §709.010(b)

Probate Code §15301(b) appears to require that the judgment creditor pursue a petition under CCP §709.010(b) (see §10A.12; for a sample form, see §10A.14) even if the trust estate or a portion of it is supposed to be delivered to the debtor-beneficiary. Section 15301(b) states:

> After an amount of principal has become due and payable to the beneficiary under the trust instrument, upon petition to the court under Section 709.010 of the Code of Civil Procedure by a judgment creditor, the court may make an order directing the trustee to satisfy the money judgment out of that principal amount. The court in its discretion may issue an order directing the trustee to satisfy all or part of the judgment out of that principal amount.

Many trusts have provisions that provide for distributions at various ages, *e.g.* "one-third at age 25, one-half of the remaining principal at age 30, and the remaining balance at age 35." Once the property is distributed to the beneficiary it should be available to his or her creditors under the Enforcement of Judgments Act (CCP §§680.010-724.260). Yet, even though the beneficiary is due his or her portion on reaching the specified age, the Probate Code seems to require a petition under CCP §709.010. Because the court has discretion under Prob C §15301(b) to order the trustee to satisfy the money judgment out of the principal amount that has become due and payable to the beneficiary, it would appear that a profligate beneficiary can be saved from loss of the inheritance if the court decides to allow the trustee some sort of retention of the funds.

The statutes are unclear as to why a beneficiary who has an immediate, vested right to a distribution is able to make a voluntary assignment (see §10A.21), yet the creditor cannot compel seizure through involuntary process. One possible remedy is to fashion a request similar to that of a claim against a remainder beneficiary. See §10A.34.

NOTE: The law is unclear on the application of CCP §709.010 to a beneficiary's interest when it is fully vested by the terms of the trust, *e.g.*, when the trust instrument provides that "[t]he trust shall terminate and be distributed to the beneficiary upon his attaining age 35." It appears that, as long as the trustee retains legal possession of the assets, the creditor must file the appropriate petition under §709.010 and that a direct levy cannot be used until the assets are actually distributed. See §10A.19.

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§10A.14 C. Form: Petition to Enforce Money Judgment

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

[*Title of court*]

[*Title of case*]

Case No. _ _ _ _ _ _

PETITION TO ENFORCE JUDGMENT AGAINST TRUST BENEFICIARY
(CCP §709.010)
Hearing Date: _ _[*date*]**_ _**
Time: _ _[*time*]**_ _**
Dep't: _ _[*number*]**_ _**
Judge: _ _[*if known*]**_ _**

Petitioner, _ _[*name*]**_ _, respectfully petitions:**

1. Petitioner is a judgment creditor of _ _[*name*]**_ _, beneficiary of the _ _**[*name*]**_ _ Trust.**

2. A copy of the judgment against the named beneficiary is attached as Exhibit A.

[*Add one of the following alternatives*]

[*Alternative 1: allegations for seeking principal under Probate Code §15301*]

3. The _ _[*name*]**_ _ Trust provides that the named beneficiary's interest in principal is not subject to voluntary or involuntary transfer. Under the trust instrument, principal in the amount of $_ _**[*amount*]**_ _ will become due and payable to the named beneficiary on or about _ _**[*date*]**_ _.**

[*Alternative 2: allegations for seeking income, principal, or both, under Probate Code §15305*]

3. Under the terms of the _ _[*name*]**_ _ Trust, the named beneficiary has the right to compel the Trustee to pay _ _**[*income/principal/both income and principal*]**_ _ to or for the benefit of the named beneficiary.**

[*Add one of the following alternatives*]

[*Alternative 2a*]

Under the terms of the _ _[*name*]**_ _ Trust, the Trustee has discretion to make payments to or for the benefit of the named beneficiary.**

The amount that the named beneficiary has the right to compel the Trustee to pay is in excess of the amount that is or will be necessary for the education and support of the named beneficiary.

[*Alternative 2b*]

No amount that the Trustee has discretion to pay to or for the benefit of the named beneficiary is or will be necessary for the education and support of the beneficiary.

[*Alternative 3: allegations for seeking income, principal, or both under Probate Code §15307*]

3. The _ _[*name*]**_ _ Trust provides that the named beneficiary's interests in principal and income are not subject to voluntary or involuntary transfer. The named beneficiary is entitled _ _**[*e.g., to payment of all income from the trust, to be paid quarterly*]**_ _. The Trustee may pay to or for the benefit of the named beneficiary such additional amounts of principal as the Trustee, in the Trustee's absolute discretion, deems appropriate. None of the income and none of the amount that the Trustee has discretion to pay to or for the benefit of the named**

beneficiary is or will be necessary for the education and support of the beneficiary.

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: names and addresses known*]

4. The names and addresses of the beneficiaries of the Trust are as follows:

_____ _____

_____ _____

_____ _____

[*Alternative 2: names and addresses unknown*]

4. Petitioner does not know the names and addresses of all the beneficiaries of the Trust. The name and address of the beneficiary-judgment debtor is:

_____ _____

[*Continue*]

Petitioner requests:

1. That the Court order payment of the judgment entered against _ _[*name of beneficiary-judgment debtor*]**_ _ from _ _**[*his/her*]**_ _ interest in the Trust in the following manner:**

[*E.g., add the following, or describe*]

Trustee is ordered to pay to Petitioner all income now payable or that becomes payable to _ _[*name of beneficiary-judgment debtor*]**_ _ above the amount of $_ _**[*amount*]**_ _ quarterly. Trustee is further ordered to make no discretionary payments to _ _**[*name of beneficiary-judgment debtor*]**_ _ until the judgment referred to above together with all interest on the judgment is paid in full; and is ordered, when exercising discretion to make payments to or for the benefit of _ _**[*name of beneficiary-judgment debtor*]**_ _, to make the payments to Petitioner until the judgment referred to above, together with all interest on the judgment, is paid in full.**

[*Continue*]

2. That all other proper orders be made.

Date: _ _ _ _ _ _ __[*Signature of petitioner*]__
_ _[*Typed name*]_ _

[*Verification; see §7.116*]

Comment: If the petitioner does not have reliable knowledge of the names of beneficiaries and terms of the trust instrument, the allegations and verification will have to be on information and belief. If the creditor's attorney is uncertain about the existence, terms, and content of the trust, he or she should consider petitioning for an order of examination to ascertain the information before filing this petition. See Debt Collection Practice in California §§8.15-8.19 (2d ed Cal CEB 1999).

These sample allegations rely on Prob C §15307, which permits application of any amounts over those required for the beneficiary's education and support rather than on Prob C §15306.5, which limits the amount that can be reached.

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§10A.15 D. Effect of Petition Under CCP §709.010

Provisions for court orders approving petitions under CCP §709.010 appear in Prob C §§15300-15307. Probate Code §§15301, 15306, 15306.5, and 15307 all authorize court orders to satisfy a money judgment (in the case of §15306, a "liability" rather than a judgment) from some specified interest of the debtor-beneficiary. Probate Code §15303(b) restricts the trustee from making discretionary payments that would impair a creditor's rights following the filing of such a petition.

NOTE: Although Prob C §15305, dealing with child and spousal (and registered domestic partner; Fam C §297.5) support judgments, makes no reference to a petition under CCP §709.010, the exclusivity provision of §709.010(b) apparently requires the use of this procedure to obtain an order under Prob C §15305.

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§10A.16 E. Form: Order Enforcing Judgment

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[*Title of court*]

_ _[*Title of case*]_ _ **Case No. _ _ _ _ _ _**

ORDER ENFORCING JUDGMENT AGAINST TRUST BENEFICIARY (CCP §709.010)

The verified petition of _ _[*name of petitioner*]_ _, as judgment creditor of _ _[*name of beneficiary-judgment debtor*]_ _, beneficiary of the above-entitled trust, was duly presented to this Court.

On proof made to the satisfaction of the Court, the Court finds that the allegations in the petition are true; that all proper notices of hearing have been given as required by law; and good cause appearing, grants the petition as follows:

IT IS ORDERED that:

1. Trustee shall pay to Petitioner all income now payable or that becomes payable to _ _[*name of beneficiary-judgment debtor*]_ _ above the amount of $_ _[*amount*]_ _ quarterly until the sum stated above has been paid, together with interest on the unpaid balance from the date of this order at the rate of _ _[*number*]_ _ percent. Trustee is further ordered to make no discretionary payments to _ _[*name of beneficiary-judgment debtor*]_ _ until the sum stated above, together with interest, is paid in full; and is ordered, when exercising discretion to make payments to or for the benefit of _ _[*name of beneficiary-judgment debtor*]_ _, to make the payments to Petitioner until the amount stated above, together with all interest on the judgment, is paid in full.

2. This order shall remain in effect until the judgment of Petitioner is satisfied in full or this order is modified or terminated.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the _ _[*title of court*]_ _

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III. VOLUNTARY TRANSFERS

§10A.17 A. Transfers Before Settlor's Death

The settlor of a revocable living trust may make voluntary transfers of income or principal without restraint. The settlor may reserve this power in the trust instrument or may direct the trustee to make such transfers under Prob C §§16001 and 16462. The settlor may also revoke the trust for the portion being transferred. Prob C §15401. See also §10.3 for discussion of how persons other than the transferor may be treated as the settlor of a trust.

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B. Transfers by Beneficiaries After Settlor's Death

§10A.18 1. No Spendthrift Clause

If there is no spendthrift clause in the trust instrument, the beneficiary of such trust is free to transfer his or her interest for consideration or by gift, or to ask the trustee to pay creditors directly from the trust. See §10A.19. (However, this does not apply to a beneficiary with a discretionary interest. See §10A.20.) The beneficiary should notify the trustee in writing of the transfer. See §§10A.21-10A.22 for sample forms of assignment by beneficiary and notification to trustee.

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§10A.19 a. Effect of Transfer or Assignment

When an interest in a trust is validly sold, assigned, or transferred by court order to a creditor, the purchaser, assignee, or creditor (transferee) obtains the same rights as the original holder of the interest. *DiMaria v Bank of Cal.* (1965) 237 CA2d 254, 46 CR 924.

Although there are no cases on point, it appears that the transferee has the same rights to information that the original beneficiary had. If a beneficiary's interest has been irrevocably assigned or sold, the trust income subsequently distributed is taxable to the purchaser. See *Blair v Commissioner* (1937) 300 US 5, 81 L Ed 465, 57 S Ct 330. The trust's tax returns should name the assignee or the purchaser as the party responsible for the tax. If the interest was assigned temporarily, then the income is taxable to the beneficiary as if the assignment had not taken place. See *Harrison v Schaffner* (1941) 312 US 579, 85 L Ed 1055, 61 S Ct 759, in which the court held that a trust beneficiary who made a 1-year assignment of trust income to her children was subject to income tax on it. See also *Iber v U.S.* (7th Cir 1969) 409 F2d 1273. The purchaser or assignee is subject to the same limitations as the original beneficiary; the purchaser or assignee cannot direct the trustee to change the investments, for example, to favor the purchaser at the expense of other beneficiaries.

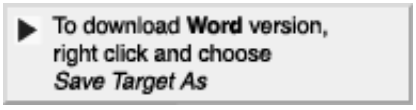
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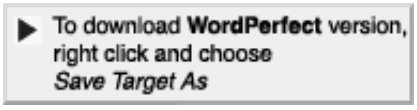
§10A.20 b. Limitation: Discretionary Power

A beneficiary has no rights in trust property over which the trustee has a discretionary power. Therefore, the beneficiary cannot transfer his or her interest, and there is no property for a creditor to reach until the trustee exercises his or her discretion. Prob C §15303(a). A creditor of the beneficiary has no greater rights than the beneficiary. See *DiMaria v Bank of Cal.* (1965) 237 CA2d 254, 257, 46 CR 924. See also *Estate of Canfield* (1947) 80 CA2d 443, 452, 181 P2d 732, in which the court held that, when the trustee has absolute discretion to divide income between two beneficiaries, each beneficiary has only an expectancy, and therefore neither the beneficiaries nor their creditors may compel an allocation or distribution.

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§10A.21 c. Form: Assignment by Beneficiary





For value received I, _ _[*name of beneficiary*]_ _**, of** _ _[*address*]_ _**, California, assign to** _ _[*name of assignee*]_ _**, of** _ _[*address*]_ _**, California, referred to as assignee,** _ _[*all of my right, title, and interest in the income of the trust/$*_ _[*amount*]_ _ *per year, including the current calendar year, from the income of the trust fund*]_ _ **established by** _ _[*the Trust Agreement between* _ _[*name*]_ _ *as Settlor and* _ _[*name*]_ _ *as Trustee, dated* _ _[*date*]_ _*/the Declaration of Trust by* _ _[*name*]_ _ *as Settlor, dated* _ _[*date*]_ _*/the Will of* _ _[*name of testator*]_ _]_ _ **for the balance of my life. To the extent of the assignment, I hereby substitute assignee for myself as beneficiary of the above-named Trust.**

I further direct the Trustee of the named Trust to remit directly to assignee all moneys and benefits accruing from the interest assigned and to consider assignee a beneficiary under the Trust to the extent of the interest.

If the Trustee fails to remit the sum assigned in each and every year, I appoint assignee as my attorney-in-fact, with full power of substitution and revocation, in _ _[*his/her*]_ _ **own name, to demand, sue for, collect, receive, and compel Trustee to account to** _ _[*him/her*]_ _ **and give acquittal for the annual income assigned to** _ _[*him/her*]_ _ **by this assignment.**

In witness whereof, I have executed this assignment at _ _[*designate place of execution*]_ _ **on** _ _[*date*]_ _**.**

__[*Signature*]__
_ _[*Typed name*]_ _

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§10A.22 d. Form: Notice to Trustee of Assignment

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To _ _[*name of trustee*]_ _**, Trustee of the Trust created** _ _[*by* _ _[*name of settlor*]_ _ *in trust instrument dated* _ _[*date*]_ _*/under the Will of* _ _[*name of testator*]_ _]_ _**:**

You are hereby notified that I, _ _[*name of beneficiary*]_ _**, have this day assigned to** _ _[*name of assignee*]_ _**, of** _ _[*address*]_ _**, California,** _ _[*all of my right, title, and interest in the income of the Trust/*$_ _[*amount*]_ _ *per year, including the current calendar year, from the income of the trust fund*]_ _**. A copy of the original of the assignment is attached and made a part of this notice.**

You are hereby authorized to make the assigned payments from income as and when they become payable to _ _[*name of assignee*]_ _**.**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

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§10A.23 2. Spendthrift Clause

Statutory provisions regarding restraints on alienation are currently found in Prob C §§15300-15309. California trust law permits absolute restraints on voluntary alienation. See §§10A.1-10A.16. Although a settlor cannot impose on his or her own trust a spendthrift restriction applicable to the settlor as a beneficiary (Prob C §15304(a)) (but see §10A.26), so-called spendthrift clauses may prohibit a beneficiary other than the settlor from transferring his or her interest in the trust, with or without consideration (Prob C §§15300-15301). The restraint on the beneficiary applies, however, only until any trust distributions are made and are no longer part of the trust. Before the distributions are actually in the beneficiary's possession, court approval will be required for any taking. See §10A.13. A beneficiary also may request a transfer of trust distributions to the creditor. See §10A.24.

Once the beneficiary receives the trust distribution, it is such beneficiary's personal asset. He or she can transfer it at will and judgment creditors can reach it directly through the Enforcement of Judgments Act (CCP §§680.010-724.260). *Frazier v Wasserman* (1968) 263 CA2d 120, 69 CR 510; *Estate of Schneider* (1956) 140 CA2d 710, 296 P2d 45; *Kelly v Kelly* (1938) 11 C2d 356, 79 P2d 1059. For example, a valid contract to assign in the future (as opposed to a present-day assignment) can be enforced against the beneficiary. Once the assets are distributed to the beneficiary personally (as contrasted with assets still in the possession of the trustee), they are subject to execution on a judgment against the beneficiary. *Kelly v Kelly, supra*. When a surcharge is imposed against a trustee who is also a beneficiary, the existence of a spendthrift clause does not prevent the court from impounding that beneficiary's share of the trust estate to satisfy the surcharge. *Chatard v Oveross* (Nov. 30, 2009, B213392) 2009 Cal App Lexis 1908.

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§10A.24 a. Convenience Transfers

For convenience, or under pressure from creditors, the beneficiary may seek to have the trustee transfer trust distributions directly to creditors. The beneficiary may also ask the trustee to make a gift to a third party from the trust interest the beneficiary is currently entitled to receive. On the revocability of such requests, see 3 Scott & Ascher on Trusts §15.2.5 (5th ed 2007).

PRACTICE TIP: Transfer of real property assets can be frustrated by the recordation of a lis pendens under CCP §§405.1-405.24. See *Kirkeby v Superior Court* (2004) 33 C4th 642, 15 CR3d 805. However, at least one court has held that a complaint seeking imposition of a constructive trust on real property that was allegedly improved with money acquired by undue influence did not establish a "real property claim" for purposes of the lis pendens statute. Accordingly, the lis pendens in that case was properly expunged. See *Campbell v Superior Court* (2005) 132 CA4th 904, 34 CR3d 68.

Although the trustee is well within his or her rights to refuse such a request from a beneficiary, it may ease the beneficiary's personal financial situation and benefit the creditors because they may feel more secure in receiving payments from a reliable source on a definite schedule. The trustee may not wish to deal with the beneficiary's creditors if they are numerous or the trustee does not have the time to handle the paperwork. The trustee's attorney should review the beneficiary's written request and the terms of the specific spendthrift clause to be sure the wording of the request cannot be construed as an attempted assignment of the beneficiary's interest and does not violate any provisions of the spendthrift clause.

A form of such a request to the trustee is provided in §10A.25.

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§10A.25 b. Form: Request for Transfer to Creditor

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I, _ _[*name of beneficiary*]_ _, hereby request that _ _[*name of trustee*]_ _, as Trustee, pay from the income that is from time to time due me from the Trust, _ _[_ _[*number*]_ _ *percent/$*_ _[*amount*]_ _]_ _ _ _[*e.g., monthly or quarterly*]_ _, _ _[*in equal amounts/in proportion to the amount stated*]_ _, to those creditors of mine _ _[*listed below/whose bills I forward to you for payment*]_ _ until I request that you cease making such payments. I understand I have no legal right to direct or demand that you, as my Trustee, make these payments, but ask that they be made as an accommodation to me.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

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§10A.26 C. "Self-Settled" Spendthrift Trusts From Other Jurisdictions

Although this text deals with California law, a brief mention should be made of the increasing interest in "asset protection" trusts. The use of foreign bank accounts located in Switzerland, Liechtenstein, the Cayman Islands, Bahamas, and even more exotic ports of call such as Saint Vincent and the Grenadines, Nevis, or the Cook Islands (the trust laws in these jurisdictions are similar because Saint Vincent and Nevis based their trust laws on the laws of the Cook Islands) have been used for years by those seeking "protection" from creditors. However, California residents will find this goal somewhat difficult to achieve.

First, a spendthrift restriction applicable to the settlor as a beneficiary is not recognized under Prob C §15304(a). See §10A.23. It is possible, however, to create trusts that are not subject to the claims of creditors of either the settlors or beneficiaries who may receive discretionary distributions so long as the settlor is not a beneficiary of the trust. Prob C §15303.

Second, the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12) will provide a remedy in California (or in states that enacted similar provisions) to attack a transfer into a trust, which is really a transfer without consideration. See §10A.27. Such transfers also may be avoidable in bankruptcy. See §10A.28.

Third (and most ominous), courts in at least two cases have ordered settlors to repatriate assets of foreign trusts and pay creditors or be held in contempt of court. See *FTC v Affordable Media, LLC* (9th Cir 1999) 179 F3d 1228 (often referred to as the "Anderson" case). See also *Lawrence v Goldberg (In re Lawrence)* (11th Cir 2002) 279 F3d 1294, 1300. For further discussion, see Stein, *Importance of Trusts in Asset Protection*, 12 Cal Trusts & Est Q 17, 22 (Winter 2007).

NOTE: An attorney advising clients with respect to asset protection must be careful that the client's problem does not become the attorney's problem. In *Morganroth & Morganroth v Norris, McLaughlin & Marcus, P.C.* (3d Cir 2003) 331 F3d 406, the court held that a judgment creditor stated various causes of action against a judgment debtor's attorneys who participated in the client's unlawful conduct to hinder, delay, or fraudulently obstruct the enforcement of a judgment. For a case involving a civil conspiracy cause of action in connection with a fraudulent conveyance, see *Monastra v Konica Bus. Machs., U.S.A., Inc.* (1996) 43 CA4th 1628, 1644, 51 CR2d 528. See also *Gutierrez v Givens* (SD Cal 1997) 989 F Supp 1033.

Nevertheless, first Alaska, then Delaware, and now several other states have enacted some versions of "self-settled" spendthrift trusts that are supposedly "judgment-proof." Alaska Stat §§13.36.035(c), 13.36.310; 12 Del Code §§3536(c), 3570-3576. However, Delaware has implemented a version of the Uniform Fraudulent Transfer Act (6 Del Code §§1301-1311), and Alaska law contains an exception for property transferred to a trust with intent to defraud creditors which, however, is not evidenced by a settlor's expressed intention to protect trust assets from potential future creditors (Alaska Stat §34.40.110(b)). In any case, attorneys and trust companies in those states must be consulted. See Shaftel, *Alaska's Experience With Self-Settled Discretionary Spendthrift Trusts*, 29 Est Plan 506 (2002); Nenno & Sullivan, *Delaware Asset Protection Trusts Create Obstacles for Creditors*, 33 Est Plan 3 (Dec. 2005).

There are valid reasons for using "off-shore" trusts, such as to provide for the support of a child who might live with relatives abroad if the United States parents might die. However, as illustrated by *FTC v Affordable Media, LLC, supra,* the person, as well as the assets, may need to be relocated outside of the jurisdiction of the federal courts if the settlors wish to erect barriers to their creditors, which makes "off-shoring" of assets unrealistic for most.

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§10A.27 1. Fraudulent Transfers

A transfer without consideration is fraudulent if a debtor is engaged in a business and the transfer leaves the debtor with remaining assets that are unreasonably small in relation to the business, or if the debtor believed or reasonably should have believed that he or she would incur debts beyond his or her ability to pay. CC §3439.04(a).

NOTE: The application of the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12) will affect the attempt to establish a "self-settled" trust. California case law frowns on such attempts. For example, in *Filip v Bucurenciu* (2005) 129 CA4th 825, 28 CR3d 884, the court applied the UFTA to a supposed "marital settlement agreement" between a divorcing couple, by which a judgment debtor tried to give all his assets to his wife. Despite the couple's protests, the court held that "[p]roof [of a fraudulent transfer] often consists of inferences from the circumstances surrounding the transfer." 129 CA4th at 834.

The transfer may be considered fraudulent if there is evidence of traditional "badges of fraud" such as retained possession or control of trust assets. See CC §3439.04(b)(2). The transfer also may be considered fraudulent if the debtor transfers substantially all of the debtor's assets. See CC §3439.04(b)(5). In *U.S. v Townley* (ED Wash, July 29, 2004, No. CS-02-0384-RHW) 2004 US Dist Lexis 29722, aff'd (9th Cir 2006) 97 AFTR2d 2484, the court held that trust assets could be reached to satisfy a judgment against the settlors even though they were not beneficiaries of the trust and there were no creditors at the time of the transfer. The court first concluded that there was direct evidence of intent to defraud creditors in the form of a settlor's statement that the transfers were intended to protect the transferred assets "from the claims" of future judgment creditors. The court further concluded that the settlors retained possession and control of trust property because they continued to reside in a residence after it was transferred to the trust and did not pay rent.

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§10A.28 2. Avoidance of Transfers in Bankruptcy

Under 11 USC §548(e), transfers made to a "self-settled trust or similar device" within 10 years before filing a bankruptcy petition may be avoided by the trustee in bankruptcy if the transferor is a beneficiary of the trust or device and the transfer was made with actual intent to hinder, delay, or defraud any creditor or the transfer was made in anticipation of a monetary judgment, settlement, civil penalty, or fine incurred by specified securities law violations. However, the application of this provision is unclear, and a restriction on the transfer of a beneficial interest that is enforceable under applicable nonbankruptcy law is generally enforceable in bankruptcy. 11 USC §541(c)(2). See Nenno & Sullivan, *Delaware Asset Protection Trusts Should Survive Bankruptcy*, 33 Est Plan 31 (Jan. 2006).

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§10A.29 D. Use of Disclaimers

If the trust provides for distribution by right of representation, or similar language, beneficiaries who are heavily in debt may wish to exercise their right to disclaim a pending distribution from a trust so that the property can then pass to their children in lieu of being reached by their creditors. However, as noted in §13.39, a disclaimer is ineffective against a federal tax lien. Contingent beneficiaries must take care to avoid actions that might preclude a future disclaimer of their right to a trust distribution. In *Cassell v Kolb (In re Kolb)* (9th Cir 2003) 321 F3d 868, the court held that a debtor's loan application claims of ownership of a trust future interest constituted "acceptance" of that interest under California law. Prob C §285; *Estate of Sagal* (1979) 89 CA3d 1003, 153 CR 128 (acceptance is demonstrated if beneficiary's actions produce some immediately tangible benefit that is more than de minimis). Accordingly, the debtor's subsequent attempt to disclaim the interest before filing a bankruptcy petition in *Cassell v Kolb* was ineffective. On remand, the bankruptcy court held that the trustees were jointly and severally liable for distributions to sons of the trust beneficiary who purportedly disclaimed his contingent interest in the trust property. *Cassell v Globerson (In re Kolb)* (Bankr ND Cal, May 29, 2007, No. 97-32321) 2007 Bankr Lexis 1896. The court rejected the argument that the trustees had no obligation to withhold distributions pending the determination of the appeal to the Ninth Circuit from the court's earlier ruling that the disclaimer was valid. Under *Arluk Med. Ctr. Indus. Group, Inc. v Dobler* (2004) 116 CA4th 1324, 11 CR3d 194 (*Dobler II*), discussed in §10.6, a trustee in proper circumstances can make a distribution to beneficiaries without incurring personal liability to unpaid creditors, because the trustee's sole duty is to the beneficiaries, but the *Kolb* case involved a dispute among alleged beneficiaries.

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IV. HOLDERS OF POWERS OF APPOINTMENT

§10A.30 A. General Powers of Appointment

A trust instrument may grant a beneficiary a general power of appointment over the principal of the trust, exercisable during the beneficiary's lifetime (see §10A.31) or by testamentary disposition (see §10A.32), or both. See generally Prob C §§600-695. A general power of appointment may be given to a spouse to qualify an interest for the estate tax marital deduction (IRC §2056(b)(5)), or given to a child to avoid the generation-skipping transfer (GST) tax on the amount in excess of the settlor's GST exemption by making the child the GST tax transferor of the trust (IRC §§2041(b)(1), 2514(c), 2652(a)), or given to anyone to control the disposition of the trust estate. By making it a testamentary power, the trust settlor can preserve the corpus of the trust from immediate consumption by the holder of the power, even though the holder's creditors will have recourse if the holder's own assets (probate or trust) are insufficient to pay his or her obligations that exist at the holder's death.

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§10A.31 1. Lifetime Power of Appointment

During the lifetime of the holder of a presently exercisable general power of appointment (as contrasted to one exercisable only on death, *e.g.,* in the holder's will), the trust assets subject to such general power are liable for the holder's debts as if the assets were owned by the holder, to the extent the holder cannot satisfy creditors from his or her own assets. Prob C §682(a). If the power of appointment can be exercised only through a testamentary disposition, the assets are protected from the holder's creditors during the holder's lifetime. Prob C §682(b). This distinction between types of powers derives from the fact that the holder of a lifetime power could appoint the assets directly to the creditors or to anyone, including the holder. Thus, the trust assets are reachable as if they were already distributed to the donee of the lifetime power. However, because the holder of a testamentary power cannot appoint the assets to any person or entity except by testamentary transfer, the creditors, having no greater rights than the debtor, cannot reach them.

The procedure provided by CCP §§709.010-709.020 may be used for reaching assets subject to a power of appointment in a trust during the lifetime of the power holder. For discussion and forms of petition and order, see §§10A.12-10A.16. However, if the court finds that the power holder is a "settlor" for purposes of Prob C §850(a)(3)(C), a third party creditor apparently does not have standing to file a petition under Prob C §17200. An action under Prob C §850 is the appropriate remedy.

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§10A.32 2. Testamentary Power of Appointment

If the beneficiary holds a testamentary general power of appointment over the trust property (*i.e.,* a power of appointment exercisable only at death), the beneficiary's creditors may reach the property subject to the power at the beneficiary's death, but only if the beneficiary's estate is insufficient to satisfy claims and administration expenses. Prob C §682(b). This rule applies whether or not the power has been exercised (Prob C §§682(c), 683), and is similar to the rule applicable to creditors' claims against the assets of a revocable trust on the death of the settlor under Prob C §19001. See §10.4.

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§10A.33 B. Special Powers of Appointment

Property subject to a special power of appointment (*i.e.,* one not exercisable in favor of the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate (see Prob C §611(a); see also IRC §§2041(b)(1), 2514(c)) cannot be reached by creditors of the beneficiary holding the power, either during life or after death. Prob C §681.

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§10A.34 V. REMAINDER BENEFICIARIES

A remainder beneficiary's interest normally is not transferable. Most remainder beneficiaries are not vested until the termination of all the income interests. Because the transferee may receive nothing (*e.g.,* when the lifetime beneficiary's needs may exhaust the corpus), it is unusual that a transfer will be made for value between the remainderman (even if vested) and a purchaser for value. If the trust corpus is large and the income beneficiary is near death, some sort of contractual arrangement may be possible. However, a creditor may seek to reach the interest of a remainder beneficiary. In such a case, the creditor should file a petition under CCP §709.020, which expressly applies to contingent remainders. For petition and order forms, see §§10A.14, 10A.16. Fashioning an effective remedy may require creative drafting; CCP §709.020 suggests that a lien against, or a sale of, the contingent interest may be possible, but it leaves the door open for other remedies. When the remainderman's interest is contingent, these remedies have an all-or-nothing quality that may satisfy no one. If the contingency occurs, the creditor can be paid according to the terms of the CCP §709.020 judgment; if the contingency does not occur, neither the beneficiaries nor the creditors get anything.

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11

Income Taxation of Trusts

Marc M. Stern
Robert S. Tippett

I. BASIC CONCEPTS AND FILING REQUIREMENTS §11.1

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§11.1 I. BASIC CONCEPTS AND FILING REQUIREMENTS

This chapter focuses on the basic concepts and terminology of trust income taxation (see §§11.13-11.70) and discusses the trustee's responsibility for preparing and filing returns and paying the tax due (see §§11.2-11.11, 11.75-11.82). The forms required for these procedures are discussed in §§11.8-11.12, 11.71-11.74.

For a complete discussion of federal taxation of trusts, see Ferguson, Freeland & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries (3d ed 1998); Acker, *Income Taxation of Trusts and Estates*, 852-3d Tax Management Portfolios (2007).

Federal tax forms, instructions, and publications are available on the Internal Revenue Service's website at http://www.irs.gov or by calling (1-800-TAX-FORM (1-800-829-3676)). California tax forms, instructions, and publications are available on the Franchise Tax Board's website at http://www.ftb.ca.gov or by calling 1-800-338-0505.

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§11.2 II. RESPONSIBILITY FOR PREPARING TAX RETURNS AND FURNISHING INFORMATION TO BENEFICIARIES

The trustee is responsible for the preparation and timely filing of a trust's income tax returns, as well as for the correctness of the information included and the timely payment of any tax due on the returns. IRC §§6012(b)(4); Treas Reg §1.641(b)-2(a); Rev & T C §18508(a); 18 Cal Code Regs §18505-1. Although only one trustee needs to sign the returns (IRC §6012(b)(5); Rev & T C §18508(b)), all cotrustees should review them because all cotrustees share the responsibility for their correctness (see Prob C §16013). The trustee must file a separate return for each trust, even if two or more trusts have the same settlor and the same beneficiaries. Treas Reg §1.6012-3(a)(4). See §§11.61-11.66 for time and filing requirements.

Generally, a trust must file a California return if (1) the net taxable income is over $100 or (2) the gross income exceeds $10,000, regardless of the net taxable income. Rev & T C §18505(e)-(f). A federal return must be filed if the trust has any taxable income or gross income of $600 or more, regardless of the amount of taxable income. IRC §6012(a)(4).

PRACTICE TIP: Even if the trust has less than $600 of income, it may be useful to prepare and file a fiduciary return (IRS Form 1041 (U.S. Income Tax Return for Estates and Trusts)), because the absence of a return may result in computer-generated notices to the fiduciary from the Internal Revenue Service requesting the filing of a return. If a federal return is filed and no California return is filed because it is not required, the result might be a computer notice demanding a California return.

The general rules of reasonable care, skill, and caution required by Prob C §16040 apply to the preparation of tax returns. See generally §2.17. A trustee who has expertise in the preparation of trust tax returns may be held to a higher standard of care if the trustor was relying on that expertise in choosing the trustee. See Prob C §16014. Due care and caution may require trustees inexperienced in trust taxation to employ an accountant or attorney to prepare the trust's tax returns, rather than to prepare them personally. Corporate trustees often prepare the trust's income tax returns, although they not infrequently employ outside accountants to prepare the returns, particularly if the trust has unusual income items or deductions. See §11.3.

IRS Form 56 (Notice Concerning Fiduciary Relationship) should be filed on termination of the fiduciary relationship. See §11.9 for form. Part IV of Form 56 includes schedules for total revocation or termination or partial revocation of a fiduciary relationship, as well as a substitution-of-fiduciary schedule. Form 56 may be combined with a request for determination of estate tax and discharge under the provisions of IRC §2204(b) to eliminate fiduciary liability.

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§11.3 A. Trustee's Responsibility When Someone Else Prepares Return

An individual trustee may find it advisable to employ an accountant or attorney to prepare the trust tax returns to reduce the risk of making an error. However, the trustee, as the fiduciary, is ultimately liable for any errors on the return that result in underpayment of tax and for any penalties for failure to file on time. IRC §§6901(a)(1)(B), (b); Rev & T C §§19071-19072, 19512. The trustee should, therefore, initially determine the filing deadlines and take responsibility for making sure that any required returns are prepared and filed within the time limits. Probate Code §16012(b) imposes a duty on a trustee who has delegated preparation of tax returns to generally supervise the tax preparer.

A trustee's attorney who routinely prepares fiduciary income tax returns may be willing to accept the responsibility for preparing the returns. The attorney who provides financial or tax investment advisory services including tax planning and tax preparation, such as preparing any income tax returns, must give a privacy notice under the client notification rules. See 16 CFR pt 313 in general and 16 CFR §§313.3(k)(2)(viii), 313.18(b)(1) in particular. However, if the attorney lacks the necessary expertise, the use of an accountant is both prudent and more economical. See ABA Model Rules of Prof Cond 1.1. In any event, the attorney for the trustee should include in the retainer letter to be executed by the fiduciary (required by Bus & P C §6148) the extent and limitation of the engagement, *e.g.*, whether the attorney will be responsible for preparing fiduciary tax returns. On return preparer penalties that may apply to an attorney who advises the trustee or accountant in the preparation of the return, see §11.3A.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.3A B. Return Preparer Penalties Under IRC §6694

§11.3A B. Return Preparer Penalties Under IRC §6694

In addition to any penalties, interest, and taxes that may be due for failure to file an accurate return, if the trustee employs a tax return preparer, as defined in IRC §7701(a)(36), and the preparer recklessly or intentionally disregards the tax rules or makes a willful understatement of tax liability, the IRS may impose penalties against the preparer with respect to each return in an amount equal to the greater of $1000 or 50 percent of the income derived by the preparer with respect to the return under IRC §6694.

Penalties may be imposed on preparers (including an attorney who prepares documents used by the trustee or accountant in the preparation of the return) for understatements due to unreasonable positions taken on the return, defined as one of the following:

- Position that was not adequately disclosed on the return, as provided in IRC §6662(d)(2)(B)(ii)(I), for which there is no substantial authority (§6694(a)(2)(A)); or
- Position adequately disclosed on the return, as provided in IRC §6662(d)(2)(B)(ii)(I) and Treas Reg §1.6694-2(d)(3), for which there is no reasonable basis, as defined in Treas Reg §1.6662-3(b)(3) (§6694(a)(2)(B)).

For IRC §6694 purposes, a person who merely provides information may be one of multiple preparers if the information relates to a significant return entry ("a substantial portion of a return") that results in an understatement of tax liability. See IRC §7701(a)(36); Treas Reg §301.7701-15(b)(3). Preparation of a document other than the return itself (such as an appraisal used in preparing the return) also can cause the author of the document (including an attorney who supplied information on which the appraiser relied) to be the preparer of the return. See Treas Reg §1.6694-1(b)(1), (b)(6), Example 1.

WARNING: Conduct that results in a tax return preparer penalty also may result in a violation of Circular 230 rules governing the right to practice before the IRS. Under 31 CFR §10.2(a)(4), practice before the IRS includes preparing and filing documents. Under 31 CFR §10.34(c), practitioners are required to inform clients of penalties that are likely to apply to a position taken on tax returns and other documents submitted to the IRS. In the case of tax returns, this advice is required if the practitioner advises the client in connection with the position or the practitioner prepares or signs the return. Under 31 CFR §10.34(d), the attorney may rely in good faith on information furnished by the client but may not ignore the implications of information furnished to, or known by, the attorney and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

For interim guidance on IRC §6694, see Notice 2009-5, 2009-3 Int Rev Bull 309, discussed in 30 CEB Est Plan Rep 91 (Feb. 2009). See also Rev Proc 2009-11, 2009 Int Rev Bull 313, for a list of tax returns and claims for refund that are subject to the return preparer penalty of IRC §6694. For further discussion, see *Tax Return Preparer Penalties: New Proposed Regulations and a Possible Statutory Change*, 30 CEB Est Plan Rep 5 (Aug. 2008); *New Tax Return Preparer Penalty Guidance and Proposed Tougher Circular 230 Taxpayer Advice Rules Can Impact Practitioners Who Never Sign the Return*, 29 CEB Est Plan Rep 100 (Feb. 2008).

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§11.4 C. Attorney's Role When Trustee's Office Becomes Vacant

The duty of the trust to pay taxes and to file returns is not affected by a vacancy in the office of trustee. If a successor trustee has not yet assumed office when the tax returns are due, the attorney who represents the original trustee should apply to the federal and state taxing authorities for an extension of time to file the returns and pay the tax to prevent the imposition of penalties.

PRACTICE TIP: In the absence of cooperation by the original trustee, paying the tax may be very difficult if the attorney does not have authority to sign checks, as is usually the case. The attorney should make arrangements in advance for this possibility during the negotiations for the vacancy. IRS Form 2848 (Power of Attorney and Declaration of Representative) will allow the filing of the extensions, but only if it includes the representation of the original trustee for all current and future tax returns.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.5 D. Successor Trustee's Liability for Unpaid Taxes

§11.5 D. Successor Trustee's Liability for Unpaid Taxes

After being appointed, the successor trustee should make sure that all previously required trust income tax returns have been filed and the taxes paid. Although a successor trustee is not generally liable for the acts of the predecessor trustee (see Prob C §16403), unless the governing instrument contains protective language regarding the successor trustee's liability, the successor trustee may be liable for future penalties and interest on unpaid taxes if returns were properly prepared and filed. Generally, any fiduciary who pays any debt due by the decedent or the estate before federal tax obligations are satisfied becomes personally liable for such tax to the extent of such payments. The successor trustee may take certain actions to protect himself or herself from that liability. As noted in §11.2, IRS Form 56 (Notice Concerning Fiduciary Relationship) may be combined with a request for determination of tax and discharge under the provisions of IRC §2204(b) to eliminate fiduciary liability.

PRACTICE TIP: Before the successor trustee takes office, the issue of allocation of responsibility between the original and successor trustee should be clarified so that there is no later dispute. The successor trustee could petition the probate court under Prob C §17200(b) for a determination of the prior trustee's liability, before or as part of the process of accepting the position of trustee.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.6 E. Furnishing Information to Beneficiaries

§11.6 E. Furnishing Information to Beneficiaries

A trustee filing an income tax return must furnish a statement containing return information as required by regulation to each beneficiary (or nominee) who receives, or is required to receive, a distribution from the trust for the current year. IRC §6034A. Regulations under IRC §6034A have not yet been promulgated. In the absence of direction from the regulations, the prudent trustee should either prepare a Schedule K-1 of IRS Form 1041 (Beneficiary's Share of Income, Deductions, Credits, Etc.) for each beneficiary, or furnish the entire income tax return to each beneficiary. Section 6034A requires that the information be furnished at or before the time the return is required to be filed. California imposes a $50 penalty on the trustee for each beneficiary to whom the trustee fails to provide Schedule K-1. See Instructions for FTB Form 541 (General Information-Interest and Penalties). Note also that the trustee must withhold tax on payments of income from California sources to nonresident beneficiaries that are not subject to payroll withholding. See §11.59.

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§11.7 F. Compensation for Tax Return Preparation

Compensation of trustees and other professionals is governed by the trust instrument. Most trust instruments are silent on the specific subject of compensation for preparation of income tax returns, but do authorize the trustee to pay reasonable compensation to professionals, such as accountants. When the trust is silent, Prob C §16243 authorizes the trustee to pay reasonable compensation to agents of the trust. See §§9.41-9.42.

Under 31 CFR §10.27 an attorney may charge a contingent fee (based on whether a position taken on the return avoids challenge or is sustained by the IRS) only in connection with an IRS examination of, or challenge to, the original return, or an amended return or claim for refund or credit filed within 120 days after the taxpayer receives a written notice of the examination or challenge.

If the trust is subject to court supervision, court approval of the fees will be required. Local court rules should be consulted prior to hiring an accountant to determine if the court has published fee guidelines for compensation of professionals. If the fees incurred exceed the published fee, extraordinary fees may be requested. See §9.44.

Corporate trustees often prepare trust income tax returns in-house for no additional charge, although some trustees charge a fee for preparation of the returns in addition to their basic trustee compensation. See §9.10.

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III. INITIAL REQUIRED TAX FORMS

A. IRS Form 56: Notice Concerning Fiduciary Relationship

§11.8 1. Filling Notice

Immediately after a trust is established or a successor trustee assumes office, the trustee should file notice with the IRS that a fiduciary relationship exists between the trustee and the trust (the notice is not required for grantor trusts). See IRC §§6903, 7701(a)(6); Treas Reg §301.6903-1. Completion and filing of IRS Form 56 fulfills this requirement. The form may be obtained from any IRS office or the IRS website and should be filed with the district director for the district where income tax returns will be filed. If the form is not filed, deficiencies may be noticed, assessed, and demanded without direct notice to the fiduciary (notices sent to a deceased or other person subject to liability at his or her last known address are sufficient notice for IRS purposes under IRC §6212(b)(3)), to the detriment of the trust. Treas Reg §301.6903-1(c). For the definition of "last known address," see Treas Reg §301.6212-2.

For form, see §11.9.

NOTE: California does not have an equivalent form, but the Franchise Tax Board accepts IRS Form 56. See FTB Publication 1006. A signed and dated original Form 56 can be mailed to Franchise Tax Board, PO Box 942840, Sacramento, CA 94240-0040. File each of these notices with the agency by certified mail, return receipt requested. Request the return of a conformed copy, showing filing. Provide a self-addressed return envelope for this purpose.

PRACTICE TIP: On commencement of representation, if the attorney cannot confirm that the notice has been filed, a new form should be executed and filed. Part V of IRS Form 56 also may be used by a predecessor trustee to terminate the fiduciary relationship and relieve the trustee of any further liability, but this does not relieve the successor trustee of the requirement to complete and file the form or otherwise give notice.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.9 2. Form: Notice Concerning Fiduciary Relationship (IRS Form 56)

§11.9 2. Form: Notice Concerning Fiduciary Relationship (IRS Form 56)



Form **56**
(Rev. December 2007)
Department of the Treasury
Internal Revenue Service

Notice Concerning Fiduciary Relationship

(Internal Revenue Code sections 6036 and 6903)

OMB No. 1545-0013

Part I Identification

Name of person for whom you are acting (as shown on the tax return)	Identifying number	Decedent's social security no.

Address of person for whom you are acting (number, street, and room or suite no.)

City or town, state, and ZIP code (If a foreign address, see instructions.)

Fiduciary's name

Address of fiduciary (number, street, and room or suite no.)

City or town, state, and ZIP code	Telephone number (optional)
	( )

Part II Authority

1 Authority for fiduciary relationship. Check applicable box:

a(1) ☐ Will and codicils or court order appointing fiduciary . . . . . (2) Date of death .....

b(1) ☐ Court order appointing fiduciary . . . . . (2) Date (see instructions) .....

c ☐ Valid trust instrument and amendments

d ☐ Other. Describe ▶ .....

Part III Nature of Liability and Tax Notices

2 Type of tax (estate, gift, generation-skipping transfer, income, excise, etc.) ▶ .....

3 Federal tax form number (706, 1040, 1041, 1120, etc.) ▶ .....

4 Year(s) or period(s) (if estate tax, date of death) ▶ .....

5 If the fiduciary listed in Part I is the person to whom notices and other written communications should be sent for **all** items described on lines 2, 3, and 4, check here . . . . . ▶ ☐

6 If the fiduciary listed in Part I is the person to whom notices and other written communications should be sent for **some** (but not all) of the items described on lines 2, 3, and 4, check here ▶ ☐ and list the applicable federal tax form number and the year(s) or period(s) applicable .....

.....

Part IV Revocation or Termination of Notice

Section A—Total Revocation or Termination

7 Check this box if you are revoking or terminating all prior notices concerning fiduciary relationships on file with the Internal Revenue Service for the same tax matters and years or periods covered by this notice concerning fiduciary relationship . ▶ ☐

Reason for termination of fiduciary relationship. Check applicable box:

a ☐ Court order revoking fiduciary authority

b ☐ Certificate of dissolution or termination of a business entity

c ☐ Other. Describe ▶

Section B—Partial Revocation

8a Check this box if you are revoking earlier notices concerning fiduciary relationships on file with the Internal Revenue Service for the same tax matters and years or periods covered by this notice concerning fiduciary relationship . . . . . ▶ ☐

b Specify to whom granted, date, and address, including ZIP code.

▶ .....

Section C—Substitute Fiduciary

9 Check this box if a new fiduciary or fiduciaries have been or will be substituted for the revoking or terminating fiduciary and specify the name(s) and address(es), including ZIP code(s), of the new fiduciary(ies) . . . . . ▶ ☐

▶ .....

Part V Court and Administrative Proceedings

Name of court (if other than a court proceeding, identify the type of proceeding and name of agency)		Date proceeding initiated	
Address of court		Docket number of proceeding	
City or town, state, and ZIP code	Date	Time a.m. p.m.	Place of other proceedings

Part VI Signature

Please Sign Here

I certify that I have the authority to execute this notice concerning fiduciary relationship on behalf of the taxpayer.

Fiduciary's signature	Title, if applicable	Date

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B. IRS Form SS-4: Application for Taxpayer Identification Number

§11.10 1. Initial Application Procedure

With the exception of grantor trusts described in §§11.75-11.81 (see Treas Reg §301.6109-1(a)(2)), every trust (including a grantor trust when it ceases to be a grantor trust) must have a federal taxpayer identification number (TIN) that is to be used on both federal and California fiduciary tax returns. IRC §6109; Rev & T C §18624. The TIN is also referred to by the IRS as an "employer identification number" (EIN), although the trust is not necessarily an employer. The assigned number is used instead of a social security number. A trustee of a newly created trust should apply to the IRS for a TIN by submitting IRS Form SS-4 (Application for Employer Identification Number). Treas Reg §301.6109-1(d)(2)(i). See also Treas Reg §301.6109-1(a). The form can be obtained from any IRS or Social Security Administration office or the IRS website. The IRS may send payroll tax forms to the trustee after Form SS-4 is filed; unless the trust has employees, these need not be filed.

For form, see §11.11.

NOTE: The Internal Revenue Service continually changes the procedures for obtaining a TIN. Consult the IRS website at http://www.irs.gov for the current procedures. As of this writing, the IRS will issue a TIN online at its website under Businesses, Employer ID Numbers, where detailed directions are available. Alternatively, to obtain a TIN by telephone, the attorney should (1) complete Form SS-4; (2) call the appropriate number at the IRS (which is currently 1-800-829-4933) and orally give the IRS representative all of the information that appears on Form SS-4; and (3) include the settlor on the call so that he or she can confirm the information given on Form SS-4 and give oral approval to the IRS representative to release a TIN to the attorney. If the settlor is deceased or otherwise unavailable, a TIN cannot be obtained by telephone, and a completed Form SS-4 must be faxed to the IRS.

NOTE: When the income of a grantor trust is taxed entirely to the grantor (or settlor), the trust does not need a separate TIN. Instead, the settlor's social security number can be used. Treas Reg §301.6109-1(a)(2). See Treas Reg §1.671-4(b).

Treasury Regulation §301.6109-1 does not apply to nonresident aliens or certain foreign entities. Treas Reg §301.6109-1(g).

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.11 2. Form: Application for Employer Identification Number (IRS Form SS-4)

§11.11 2. Form: Application for Employer Identification Number (IRS Form SS-4)



Form **SS-4**
(Rev. January 2010)
Department of the Treasury
Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)

▶ **See separate instructions for each line.** ▶ **Keep a copy for your records.**

OMB No. 1545-0003

EIN

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested

2 Trade name of business (if different from name on line 1)

3 Executor, administrator, trustee, "care of" name

4a Mailing address (room, apt., suite no. and street, or P.O. box)

5a Street address (if different) (Do not enter a P.O. box.)

4b City, state, and ZIP code (if foreign, see instructions)

5b City, state, and ZIP code (if foreign, see instructions)

6 County and state where principal business is located

7a Name of responsible party

7b SSN, ITIN, or EIN

8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? ☐ Yes ☐ No

8b If 8a is "Yes," enter the number of LLC members ▶

8c If 8a is "Yes," was the LLC organized in the United States? ☐ Yes ☐ No

9a **Type of entity** (check only one box). **Caution.** If 8a is "Yes," see the instructions for the correct box to check.

- ☐ Sole proprietor (SSN) ___ ___ ___
- ☐ Partnership
- ☐ Corporation (enter form number to be filed) ▶ ___
- ☐ Personal service corporation
- ☐ Church or church-controlled organization
- ☐ Other nonprofit organization (specify) ▶ ___
- ☐ Other (specify) ▶
- ☐ Estate (SSN of decedent) ___ ___ ___
- ☐ Plan administrator (TIN) ___
- ☐ Trust (TIN of grantor) ___
- ☐ National Guard ☐ State/local government
- ☐ Farmers' cooperative ☐ Federal government/military
- ☐ REMIC ☐ Indian tribal governments/enterprises

Group Exemption Number (GEN) if any ▶

9b If a corporation, name the state or foreign country (if applicable) where incorporated — State — Foreign country

10 **Reason for applying** (check only one box)

- ☐ Started new business (specify type) ▶ ___
- ☐ Hired employees (Check the box and see line 13.)
- ☐ Compliance with IRS withholding regulations
- ☐ Other (specify) ▶
- ☐ Banking purpose (specify purpose) ▶ ___
- ☐ Changed type of organization (specify new type) ▶ ___
- ☐ Purchased going business
- ☐ Created a trust (specify type) ▶ ___
- ☐ Created a pension plan (specify type) ▶ ___

11 Date business started or acquired (month, day, year). See instructions.

12 Closing month of accounting year

13 Highest number of employees expected in the next 12 months (enter -0- if none).

If no employees expected, skip line 14.

Agricultural	Household	Other

14 If you expect your employment tax liability to be $1,000 or less in a full calendar year **and** want to file Form 944 annually instead of Forms 941 quarterly, check here. (Your employment tax liability generally will be $1,000 or less if you expect to pay $4,000 or less in total wages.) If you do not check this box, you must file Form 941 for every quarter. ☐

15 First date wages or annuities were paid (month, day, year). **Note.** If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year) ▶

16 Check one box that best describes the principal activity of your business.

☐ Construction ☐ Rental & leasing ☐ Transportation & warehousing ☐ Health care & social assistance ☐ Accommodation & food service ☐ Wholesale-agent/broker ☐ Wholesale-other ☐ Retail
☐ Real estate ☐ Manufacturing ☐ Finance & insurance ☐ Other (specify)

17 Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided.

18 Has the applicant entity shown on line 1 ever applied for and received an EIN? ☐ Yes ☐ No

If "Yes," write previous EIN here ▶

Third Party Designee

Complete this section **only** if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.

Designee's name — Designee's telephone number (include area code) ( )

Address and ZIP code — Designee's fax number (include area code) ( )

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.

Name and title (type or print clearly) ▶ — Applicant's telephone number (include area code) ( )

Signature ▶ — Date ▶ — Applicant's fax number (include area code) ( )

Do I Need an EIN?

File Form SS-4 if the applicant entity does not already have an EIN but is required to show an EIN on any return, statement, or other document.[1] See also the separate instructions for each line on Form SS-4.

IF the applicant...	AND...	THEN...
Started a new business	Does not currently have (nor expect to have) employees	Complete lines 1, 2, 4a–8a, 8b–c (if applicable), 9a, 9b (if applicable), and 10–14 and 16–18.
Hired (or will hire) employees, including household employees	Does not already have an EIN	Complete lines 1, 2, 4a–6, 7a–b (if applicable), 8a, 8b–c (if applicable), 9a, 9b (if applicable), 10–18.
Opened a bank account	Needs an EIN for banking purposes only	Complete lines 1–5b, 7a–b (if applicable), 8a, 8b–c (if applicable), 9a, 9b (if applicable), 10, and 18.
Changed type of organization	Either the legal character of the organization or its ownership changed (for example, you incorporate a sole proprietorship or form a partnership)[2]	Complete lines 1–18 (as applicable).
Purchased a going business[3]	Does not already have an EIN	Complete lines 1–18 (as applicable).
Created a trust	The trust is other than a grantor trust or an IRA trust[4]	Complete lines 1–18 (as applicable).
Created a pension plan as a plan administrator[5]	Needs an EIN for reporting purposes	Complete lines 1, 3, 4a–5b, 9a, 10, and 18.
Is a foreign person needing an EIN to comply with IRS withholding regulations	Needs an EIN to complete a Form W-8 (other than Form W-8ECI), avoid withholding on portfolio assets, or claim tax treaty benefits[6]	Complete lines 1–5b, 7a–b (SSN or ITIN optional), 8a, 8b–c (if applicable), 9a, 9b (if applicable), 10, and 18.
Is administering an estate	Needs an EIN to report estate income on Form 1041	Complete lines 1–6, 9a, 10–12, 13–17 (if applicable), and 18.
Is a withholding agent for taxes on non-wage income paid to an alien (i.e., individual, corporation, or partnership, etc.)	Is an agent, broker, fiduciary, manager, tenant, or spouse who is required to file Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons	Complete lines 1, 2, 3 (if applicable), 4a–5b, 7a–b (if applicable), 8a, 8b–c (if applicable), 9a, 9b (if applicable), 10, and 18.
Is a state or local agency	Serves as a tax reporting agent for public assistance recipients under Rev. Proc. 80-4, 1980-1 C.B. 581[7]	Complete lines 1, 2, 4a–5b, 9a, 10, and 18.
Is a single-member LLC	Needs an EIN to file Form 8832, Classification Election, for filing employment tax returns and excise tax returns, or for state reporting purposes[8]	Complete lines 1–18 (as applicable).
Is an S corporation	Needs an EIN to file Form 2553, Election by a Small Business Corporation[9]	Complete lines 1–18 (as applicable).

[1] For example, a sole proprietorship or self-employed farmer who establishes a qualified retirement plan, or is required to file excise, employment, alcohol, tobacco, or firearms returns, must have an EIN. A partnership, corporation, REMIC (real estate mortgage investment conduit), nonprofit organization (church, club, etc.), or farmers' cooperative must use an EIN for any tax-related purpose even if the entity does not have employees.

[2] However, do not apply for a new EIN if the existing entity only (a) changed its business name, (b) elected on Form 8832 to change the way it is taxed (or is covered by the default rules), or (c) terminated its partnership status because at least 50% of the total interests in partnership capital and profits were sold or exchanged within a 12-month period. The EIN of the terminated partnership should continue to be used. See Regulations section 301.6109-1(d)(2)(iii).

[3] Do not use the EIN of the prior business unless you became the "owner" of a corporation by acquiring its stock.

[4] However, grantor trusts that do not file using Optional Method 1 and IRA trusts that are required to file Form 990-T, Exempt Organization Business Income Tax Return, must have an EIN. For more information on grantor trusts, see the instructions for Form 1041.

[5] A plan administrator is the person or group of persons specified as the administrator by the instrument under which the plan is operated.

[6] Entities applying to be a Qualified Intermediary (QI) need a QI-EIN even if they already have an EIN. See Rev. Proc. 2000-12.

[7] See also *Household employer* on page 4 of the instructions. **Note.** State or local agencies may need an EIN for other reasons, for example, hired employees.

[8] See *Disregarded entities* on page 4 of the instructions for details on completing Form SS-4 for an LLC.

[9] An existing corporation that is electing or revoking S corporation status should use its previously-assigned EIN.

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§11.12 3. When Additional or New Taxpayer Identification Numbers Are Needed

When a single trust splits into two or more trusts (*e.g.,* a division of a revocable trust on the death of one spouse into a marital deduction trust and a credit shelter trust), each new trust that is an irrevocable nongrantor trust must have a new taxpayer identification number. See Rev Rul 63-178, 1963-2 Cum Bull 609. The original number used for a trust, however, may be retained and used for any one of the trusts derived from the original trust. A survivor's trust that is revocable by the surviving spouse will use the surviving spouse's Social Security number. The Social Security number of the deceased settlor cannot be used under any circumstances. See discussion in chap 13.

When the governing instrument creates more than one trust, each trust should have its own taxpayer identification number, unless they are treated as one trust. See §11.12A. The separate trusts deemed created only for the purpose of determining distributable net income (DNI) under the separate share rule do not require separate numbers, however. See §11.46 for discussion of the separate share rule.

The trustee's failure to properly recognize separate trusts could result in a surcharge against the trustee for unnecessary taxes paid. Each separate trust is entitled to specified exemptions and credits on the fiduciary tax returns. Failure to file separate returns results in the loss of individual credits and exemptions and may cause greater taxable income to be reported by the trust or its beneficiaries. In addition, the trustee's failure to report each share as a separate trust, and thus spread the income among the several trusts, can result in increased taxes because of failure to take advantage, with respect to each trust, of the lower tax rates for the first $2300 of trust income (in 2009). See §11.32.

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§11.12A 4. Multiple Trusts Treated as One Trust

Under IRC §643(f), multiple trusts are treated as one trust if they have substantially the same settlors and substantially the same primary beneficiaries and if a principal purpose behind their separation is tax avoidance. For purposes of IRC §643(f), a husband and wife are treated as one settlor or beneficiary. For an example of multiple trusts that would be treated as one trust under IRC §643(f), see H Conf Rep No. 98-861, 98th Cong, 2d Sess, 757, 870 (1984), reprinted in 1984 US Code Cong & Ad News 1445, 1458.

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IV. BASIC CONCEPTS OF INCOME TAXATION OF TRUSTS

§11.13 A. Trust as Taxpayer or Conduit

Excluding certain grantor trusts that are treated as "owned" by a grantor or other person (see §11.57), a trust can be treated both as a conduit and as a true taxpayer for income tax purposes. To the extent that a trust is required to distribute its income or, if not required, actually distributes its income to trust beneficiaries in the same tax year the income is earned (or up to 65 days thereafter if an election is made under IRC §663(b)), the trust usually functions as a conduit. The income is taxed to the beneficiaries and the trust is allowed a deduction for the portion of the gross income that is currently distributable to the beneficiaries or properly paid or credited to them. See IRC §§651, 661. The income retains the same character in the beneficiaries' hands as it had in the hands of the trust. IRC §§652(b), 662(b). In some cases, substantially separate and independent shares of different beneficiaries in a single trust having more than one beneficiary are treated as separate trusts under the separate share rule in IRC §663(c), with the effect that distributable net income (DNI) for purposes of IRC §§661-662 is determined for each share separately. See §11.46. This separate share rule also applies in some cases for generation-skipping transfer (GST) tax purposes because of the incorporation provision in IRC §2654(b)(2) as applied by Treas Reg §26.2654-1(a)(1)(i). For discussion of GST tax issues, see §§12.70-12.78.

If a complex trust accumulates income for future distribution or does not distribute a particular form of income (as is often true with capital gains income), the trust itself becomes liable for the payment of income tax. See IRC §641.

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§11.14 B. Important Definitions

The following terms are important for a basic understanding of income taxation of trusts:

Above-the-line deductions. Above-the-line deductions are all deductions that are subtracted from gross income to determine adjusted gross income. See §11.20.

Adjusted gross income (AGI). Adjusted gross income equals gross income less all above-the-line deductions. See §§11.20-11.21.

Below-the-line deductions. Below-the-line deductions are all deductions other than above-the-line deductions. See §11.21.

Complex trust. A complex trust is any trust that is not a simple trust in the year for which the determination is being made. See §§11.41-11.46.

Distributable net income (DNI). Distributable net income equals the trust's tentative taxable income plus the personal exemption plus tax-exempt income less capital gains, unless such capital gains are allocated to fiduciary accounting income or are distributed to beneficiaries, plus capital losses to the extent of capital gains included in DNI. See §11.17, 11.30.

Distribution deduction. The distribution deduction is the deduction available for distributions made to beneficiaries. See §11.30

Fiduciary accounting income (FAI). Fiduciary accounting income is income as defined under the governing trust instrument and applicable state law.

Gross income. Gross income is all income of the trust from whatever source derived. See §11.18.

Simple trust. A simple trust is any trust that is required to distribute all income, that is not required to, and does not in fact, distribute any principal, and that makes no charitable distributions. See §§11.36-11.40.

Taxable income. Taxable income equals gross income less all deductions. See §§11.17, 11.31.

Tentative taxable income (TTI). Tentative taxable income equals gross income minus all deductions (both above-the-line deductions and below-the-line deductions) other than the distribution deduction. See §§11.17, 11.30.

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C. Governing Law

§11.15 1. Internal Revenue Code

The federal rules regarding the income taxation of trusts are found in IRC §§641-692 and are structured as follows:

- General rules (IRC §§641-646);
- Simple trusts (IRC §§651-652);
- Complex trusts (IRC §§661-664);
- Treatment of excess distributions (throwback rules) (IRC §§665-668);
- Grantor trusts (IRC §§671-679);
- Miscellaneous (*e.g.*, charitable deduction limitation and income in marital dissolution situations) (IRC §§681-685); and
- Income in respect of decedents (IRD) (IRC §§691-692).

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§11.16 2. California Law Incorporates Federal Statutes

California generally follows the federal rules regarding the income taxation of trusts by incorporating federal law (IRC §§641-692) in the California statutes. Rev & T C §17731.

NOTE: California typically enacts legislation each year to adopt (or not adopt) any amendments to the Internal Revenue Code made through the end of the previous year. Thus, the Revenue and Taxation Code does not incorporate federal changes made in the current calendar year. Unless specifically provided otherwise by the Revenue and Taxation Code and noted in the sections that follow, California law tracks the federal law.

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D. Determining Taxable Income

§11.17 1. Calculation Process

The first step in calculating taxable income is to determine gross income. Above-the-line deductions are then deducted from gross income to determine adjusted gross income (AGI). Adjusted gross income is used in calculating certain below-the-line deductions by setting a floor for deduction of those expenses. For example, certain miscellaneous itemized deductions are allowable only to the extent that they exceed 2 percent of AGI. IRC §67. From AGI, all below-the-line deductions (other than the distribution deduction) are subtracted to get tentative taxable income (TTI). TTI is thus equal to gross income less all deductions other than the distribution deduction.

TTI is then used to calculate distributable net income (DNI). A trust's DNI equals its TTI plus the trust's personal exemption, plus tax-exempt income, less capital gains unless such capital gains are allocated to fiduciary accounting income (FAI) or are distributed to beneficiaries, plus capital losses to the extent of capital gains included in DNI. DNI is used to set a cap on the distribution deduction, which is the deduction available for distributions made to beneficiaries. The distribution deduction is then subtracted from TTI to determine taxable income.

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§11.18 2. Determining Gross Income

Internal Revenue Code §641(b) provides that the taxable income of an estate or trust is computed in the same manner as that of an individual, except as otherwise provided. The starting point in calculating taxable income is determining gross income. Gross income is "all income from whatever source derived." IRC §61(a).

The following types of income common to trusts are included in gross income: interest, dividends, rents, royalties, gross income derived from a business, the trust's distributive share of a partnership's gross income, income from an interest in an estate or trust, income from a life insurance policy or an endowment contract, gains from dealings in property, and income in respect of a decedent. IRC §61(a) In general, if a particular item of income would be taxable income in the hands of an individual, it will be taxable income in the hands of a trust. If it would not be taxable income in the hands of an individual, it will not be taxable income in the hands of a trust.

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3. Deductions from Trust Income

§11.19 a. Deductibility of Losses and Expenses

As a general principle, if an expense or a loss would be a tax deduction in the hands of an individual, then the expense or loss will be a tax deduction in the hands of the trust. If an expense or a loss would not be a tax deduction in the hands of an individual, then the expense or loss will not be a tax deduction in the hands of the trust.

In general, the following expenses are deductible: trade or business expenses (IRC §162); interest (IRC §163); taxes, including state taxes, local property taxes and generation-skipping taxes on taxable distributions (IRC §164); losses, including casualty or theft losses (IRC §165); bad debts (IRC §166); depreciation (IRC §§167, 642(e)); depletion (IRC §§168, 642(e)); net operating losses (IRC §§172, 642(d)); expenses and losses from activities not engaged in for profit (IRC §183); expenses incurred in the production of income (IRC §212); administration expenses, including trustee fees, professional fees, litigation expenses, and expenses incurred in obtaining tax advice (Treas Reg §1.212-1(i)); charitable contributions (IRC §642(c)); personal exemptions (IRC §642(b)); federal estate taxes paid on income in respect of a decedent (IRC §691(c)) (but not for California income tax purposes); and capital losses up to $3000 (IRC §1211(b)).

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§11.20 b. Above-the-Line Deductions

Above-the-line deductions are subtracted from gross income to determine adjusted gross income (AGI), which in turn is used to calculate certain below-the-line deductions. In general, above-the-line deductions are

- Deductions attributable to carrying on a trade or business (IRC §62(a)(1));
- Losses from the sale or exchange of property (IRC §62(a)(3)); and
- Deductions attributable to property held for the production of rents or royalties (IRC §62(a)(4)).

Special rules apply to the calculation of AGI for purposes of determining the limitation on certain below-the-line deductions. See §11.21.

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§11.21 c. Below-the-Line Deductions

Below-the-line deductions are all deductions other than above-the-line deductions.

Personal casualty losses are deductible only to the extent they exceed 10 percent of AGI. IRC §165(h)(2). For this purpose, the deductions for costs paid or incurred in connection with the administration of the trust are deducted from gross income to determine AGI. IRC §165(h)(4)(C).

Miscellaneous itemized deductions are allowable only to the extent they exceed 2 percent of AGI. IRC §67(a). For this purpose, only the personal exemption, the distribution deduction, and those costs of administration that would not have been incurred if the property were not held in the trust are treated as above-the-line deductions. IRC §67(e)(1). Thus, not all trust administration fees are treated as above-the-line deductions by §67(e)(1).

Trustees are compensated for a range of services, some of which might have been incurred even if the property were not held in trust. An example is the fee charged by the trustee for investment advice. See §9.45A. A proposed regulation provides that advice on investing for total return is not unique to trusts, and is therefore subject to the 2-percent floor. Prop Treas Reg §1.67-4. It further provides that, if the trust pays a single fee for costs that are unique and also for costs that are not unique, the trust must identify the portion of the fee that represents unique costs. In other words, it may not "bundle" fees.

In addition, the personal exemption and distribution deductions under IRC §§651 and 661 are deducted from gross income to determine AGI for purposes of determining the cap on miscellaneous itemized deductions. IRC §67(e)(2).

Excess deductions in the year of termination are below-the-line deductions and are subject to the 2-percent floor.

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§11.22 d. Net Operating Losses

If an estate or trust is engaged in a trade or business it may have a net operating loss (NOL). In general, an NOL is the amount by which the deductions attributable to the trade or business exceed gross income. IRC §172(c). In computing the NOL, deductions that are not attributable to the trade or business of a trust are allowed only to the extent of gross income not derived from the trade or business. IRC §172(d)(4). The NOL is computed without taking into account the charitable contribution deduction allowed under §642(c) or the distribution deduction allowed under IRC §§651 and 661. Treas Reg §1.642(d)-1(b).

The trust may deduct its NOL. IRC §642(d). An NOL may be carried back 3 taxable years preceding the year of the loss and may be carried forward over 15 taxable years following the year of the loss. Treas Reg §1.172-4(a)(1)(ii).

If an NOL is carried back to a prior year, it will reduce distributable net income (DNI) for that year, thereby reducing the beneficiary's income in that carryback year and permitting the beneficiary to recompute his or her tax liability for such prior year based upon the revised DNI of the trust after allowance of the net operating loss deduction. Any resulting overpayment of taxes by the beneficiary can be refunded.

In the year of termination, an unused NOL carryover may be deducted by the beneficiaries who succeed to the property of the trust. IRC §642(h).

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§11.23 e. Charitable Contribution Deduction

The deduction allowed to trusts for charitable contributions for the purposes specified in IRC §170(c) is not subject to the limits applicable to individuals. A trust's charitable deduction is limited only by its gross income, but must be made pursuant to the terms of the governing instrument. IRC §642(c). See *Brownstone v U.S.* (2d Cir 2006) 465 F3d 525, in which the court held that charitable contributions made pursuant to a beneficiary's general power of appointment were not made pursuant to the terms of the governing instrument that conferred the power of appointment. See also IRS Legal Memorandum 200848020, in which the IRS ruled that no deduction was allowed for accelerated payments to charity pursuant to a court reformation because the modification was not made in settlement of a dispute concerning interests in the trust, although the advice acknowledges that a settlement agreement arising from a will contest can result in a charitable deduction. Rev Rul 59-15, 1959-1 Cum Bull 164. In *Estate of Dehgani-Fard* (2006) 141 CA4th 797, 46 CR3d 289, the IRS allowed the estate to deduct 37.5 percent of the income from $11 million in after-discovered assets because a charity was entitled to 37.5 percent of the residue of the estate under a settlement agreement following an earlier will contest.

In addition, a trust may deduct a contribution paid after the end of a taxable year and before the last day of its following taxable year if an election is made by the trustee. IRC §642(c). Under Treas Reg §1.642(c)-1(b)(2), the election must be made not later than the time, including extensions, prescribed by law for filing the federal income tax return for the succeeding taxable year. In IRS Letter Ruling 200344021, the IRS allowed a late election to treat current-tax-year distributions to charity as made in the previous tax year. That charitable deduction is not allowed against the trust's unrelated business income (*e.g.*, income derived from conduct of a business unrelated to a charitable purpose). IRC §681.

Some trust instruments require certain classes of income to be applied to distributions to charity before other classes of income are so applied. For example, a trust provision might require that charitable distributions be made first from ordinary income, second from short-term capital gains, third from long-term capital gains, and finally from tax-exempt income, thereby applying the charitable deduction to income where the deduction will have maximum effect. However, the IRS has issued proposed regulations that would amend Treas Reg §1.642(c)-3(b)(2) to provide that such trust provisions will be disregarded if they have no economic effect independent of income tax consequences, *i.e.*, if they do not affect the amount to be distributed to charity. In the absence of such an economic effect, the deduction will be applied to all classes of income proportionately. REG-101258-08, 2008-28 Int Rev Bull 111.

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§11.24 f. Personal Exemption

For federal purposes, any trust (whether simple or complex) that is required to distribute all of its income currently is entitled to a "personal" exemption of $300. IRC §642(b)(2)(B). This includes a trust that is not a simple trust under IRC §651 because it distributes amounts other than income, or because it may be required to make a charitable contribution. It also includes a trust that must pay an annuity that equals or exceeds all of the income of the trust for the taxable year. Treas Reg §1.642(b)-1. All other trusts are entitled to an exemption of $100. IRC §642(b)(2)(A).

For California purposes, a trust is allowed a credit of $1 against the tax imposed under Rev & T C §17041, less any amounts imposed under Rev & T C §17560(d)(1), (e)(1), or both. Rev & T C §17733(b).

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§11.25 g. Deduction for Estate Tax Attributable to Income in Respect of a Decedent

Income that was "earned" but was not properly includible in a person's final return or any earlier return is called income in respect of a decedent (IRD) and is taxable to the recipient in the year it is received. IRC §691(a). See Treas Reg §1.691(a)-1(b) on the types of income that are included. Common examples of IRD include deferred compensation under executive-employment contracts, interest accrued to date of death on debts owed the decedent, and capital gain attributable to payments received after death under installment-payment contracts executed before death. However, capital gains from a predeath sale may be taxed to the decedent rather than the recipient when the proceeds are deposited in a joint tenancy account and pass to the surviving joint tenant on the decedent's death. See *U.S. v Guyton* (MD Fla 2009) 103 AFTR2d 2112.

Amounts of IRD are included in the gross income of (A) the estate of the decedent, (B) the person who acquires the right to receive the amount by reason of the decedent's death, or (C) the person who acquires the right to receive the amount from the decedent's estate. IRC §691(a)(1). Under Treas Reg §1.691(a)-4(b), if the right to receive IRD is transmitted to a specific or residuary legatee, only the legatee must include the income in gross income when received. However, if the IRD is used to satisfy a pecuniary gift, the transfer may result in the transferor estate being treated as receiving income under IRC §691(a)(2). In IRS Letter Ruling 200617020, the IRS ruled that the personal representative could use an IRA payable to the estate to partially fund a charity's right to receive a fractional share of the residue of the estate, with the result that the charity will be taxed on future IRA distributions (because the assignment of the IRA to the charity would not be a transfer within the meaning of IRC §691(a)(2)). See also IRS Letter Rulings 200633009, 200520004 (estate will not recognize income when it assigns its interests in decedent's IRAs and 401(k) account to charity in partial satisfaction of charity's right to receive fractional share of estate residue).

IRD is subject to both estate tax and income tax. As a modest relief measure, the person or entity that is eventually taxed on the IRD is allowed an income tax deduction for the federal estate tax attributable to the IRD. IRC §691(c).

The federal estate tax attributable to IRD is calculated by first aggregating all items of IRD and subtracting all allowable deductions in respect of a decedent (DRD). This amount is subtracted from the total estate and the federal estate tax is recomputed. The difference between the recomputed federal estate tax and the actual amount of the federal estate tax is the federal estate tax attributable to the IRD items. IRC §691(c)(2); Treas Reg §1.691(c)-1(a).

There is tension and interaction between the marital deduction for estate tax purposes and IRD. Special calculations are required. When the marital share bears the burden of the estate taxes, the calculation of the difference between the estate tax actually paid and the estate tax that would be owed if the IRD had not been included in the estate must take into account the reduced marital deduction that would result from not including the IRD in the marital gift. See *Estate of Cherry* (WD Ky 2001) 133 F Supp 2d 949.

If the trust will be liable for tax on only a portion of the IRD because some of the IRD is distributed to (and taxed to) beneficiaries, the deduction is prorated between the trust and the beneficiaries. IRC §691(c)(1)(B).

A similar deduction is allowed for the amount of any generation-skipping transfer (GST) tax attributable to IRD received as a part of a taxable termination or direct skip that was included in the computation of the GST tax. IRC §691(c)(3).

If the estate tax return (or GST tax return) has not yet been filed, the trustee may estimate the IRD deduction, subject to adjustment when the final estate tax (or GST tax) has been determined. Even when all of the returns have been filed, on audit the amount of tax determined may alter the available IRD deduction.

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§11.26 h. Deduction for Capital Losses

If a loss is realized on the sale or exchange of a capital asset, the trust may deduct losses up to the aggregate gains recognized plus $3000 in excess of such gains. IRC §1211(b). Any losses that are not deductible in the year incurred may be carried forward for an unlimited number of years until used. IRC §1212(b).

Generally, the loss is not included in distributable net income (DNI) because gains are not usually treated as income and distributed to beneficiaries. See IRC §643(a)(3). In those cases, the beneficiaries will not receive the benefit of the loss. In some cases, however, when capital gains are paid out to the beneficiary, capital gains and losses may be included in DNI.

No loss may be recognized on an in-kind distribution to a beneficiary because a trustee of a trust and a beneficiary of the trust are considered related taxpayers under IRC §267(b)(6). In the year a trust terminates, all capital losses (up to the amount of gains) are taken into account in computing DNI. IRC §643(a)(3). See §§11.48-11.51.

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§11.27 i. Income Versus Estate Tax Deduction

Administrative expenses allowable to an estate under IRC §2053, and losses under IRC §2054, are available as either an estate tax deduction or an income tax deduction. However, a double deduction for the same item is not allowed. IRC §642(g). It will often be advantageous to take the deduction on the estate tax return because of the higher marginal tax rate, unless there will be no estate tax on the settlor's death in any event (*e.g.,* because of a marital deduction formula), but the tax return preparer must examine each case to determine where the deduction should be taken. See chap 14.

For the trust to take one or more of these deductions on its income tax return, a statement and waiver must be filed with that return stating that no estate tax deduction has been taken for the items, and that the estate has relinquished its right to take the expense deduction for such items on the estate tax return. See IRC §642(g); Treas Reg §1.642(g)-1. Once waived, the deduction cannot later be claimed on the estate tax return. Treas Reg §1.642(g)-1.

The waiver can be filed at any time before the period of limitations for that income tax year has passed (usually 3 years; see IRC §6501). Treas Reg §1.642(g)-1. The waiver should be signed by the fiduciary for the estate because the trustee cannot bind the estate. It should be filed with the income tax return for the year for which the items are claimed as deductions, or with the district director for the internal revenue district in which the return was filed for association with the return. Treas Reg §1.642(g)-1.

Fiduciaries may choose which items to deduct on which return and also can deduct part of one expense or loss on one return and the remaining portion on the other, as long as there is no duplication of amounts. Furthermore, the double deduction rule does not apply to deductions for interest, taxes, and expenses accrued at the date of the decedent's death and allowable under IRC §§2053(a)(3) and 691(b) as deductions in respect of a decedent. Treas Reg §1.642(g)-2.

PRACTICE TIP: To be able to make the best decision regarding allocation of administrative expenses, the trustee and the fiduciary for the estate may need to secure an extension of time to file the estate tax return. When the estate plan has provided for a marital deduction with the intent to avoid estate taxes at the first spouse's death, the deductions are likely to be taken on the income tax returns.

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§11.28 j. Deductions in the Year of Termination

If total deductions exceed gross income in the year of termination of the trust, the excess deductions will flow through to the trust beneficiaries. IRC §642(h). The personal exemption and the charitable deduction are not taken into account for purposes of determining the excess deductions. IRC §642(h)(2). Excess deductions are treated as below-the-line deductions and are therefore subject to the 2-percent floor.

Any net operating loss carryovers and capital loss carryovers will also flow through to the beneficiaries in the year of termination and will have the same character in their hands that they had in the trust. The carryovers will be above-the-line deductions for purposes of computing adjusted gross income. Treas Reg §1.642(h)-1(b).

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§11.29 k. Distribution Deduction

A trust is allowed a distribution deduction equal to the lesser of the distributable net income (DNI) and either (1) the amount of income required to be distributed currently (for trusts distributing current income only) or (2) amounts paid, credited, or required to be distributed to beneficiaries (for trusts accumulating income or distributing corpus). IRC §§651, 661. The amount the trust is entitled to deduct under §§651 and 661 corresponds to the amount of the distribution that will be taxable as income to the beneficiary. The deduction is computed on Schedule B of IRS Form 1041.

A complex trust is allowed a distribution deduction for the lesser of (1) all amounts distributed or required to be distributed, whether income or principal, discretionary or mandatory (other than distributions of tax-exempt income), and (2) DNI. See IRC §661. Thus, income that is neither required to be distributed nor actually distributed is taxable to the trust, and even income that is required to be distributed or actually distributed is taxable to the trust to the extent it exceeds DNI. Distributions of principal are never taxable to the trust, but may be taxable to the beneficiaries if DNI exceeds income distributions.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.30 4. Computing Distributable Net Income

§11.30 4. Computing Distributable Net Income

Distributable net income (DNI) is determined by first calculating tentative taxable income (TTI). TTI is equal to gross income less all deductions (both above-the-line deductions and below-the-line deductions) other than the distribution deduction. DNI is then computed by adding to TTI the personal exemption plus tax-exempt income less capital gains, unless such capital gains are allocated to fiduciary accounting income (FAI) or are distributed to beneficiaries, plus capital losses to the extent of capital gains included in DNI. DNI sets a cap on the amount of the distribution deduction available to the trust and the amount of the distribution that can be included in the beneficiaries' gross incomes.

DNI is defined as the taxable income (*i.e.*, gross income less expenses) of the trust, modified as follows (IRC §643(a)):

- No distribution deductions under IRC §651 or §661 may be taken (IRC §643(a)(1));
- No personal exemption under IRC §642(b) is taken (IRC §643(a)(2));
- Capital gains are excluded if allocated to principal and not paid, credited, or required to be distributed to beneficiaries, including charitable beneficiaries under IRC §642(c), unless the gains are treated consistently as being included in DNI in tax returns filed by the trustee (IRC §643(a)(3); Treas Reg §1.643(a)-3(b)(2));
- Capital losses are excluded except to the extent they are netted against capital gains in determining what is distributed to a beneficiary (IRC §643(a)(3));
- For trusts that distribute current income only, taxable stock dividends and extraordinary cash dividends allocated by the trustee in good faith to principal, instead of being distributed to beneficiaries, are excluded (IRC §643(a)(4));
- Tax-exempt interest on state and local bonds under IRC §103, as adjusted, is included (IRC §643(a)(5)); and
- Income of foreign trusts, as adjusted, is included (IRC §643(a)(6)).

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§11.31 5. Calculating Taxable Income

Taxable income is equal to gross income less all deductions, including above-the-line deductions, below-the-line deductions, and the distribution deduction. In other words, taxable income is tentative taxable income less the distribution deduction. The amount of tax due is computed based on taxable income. See §11.32.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/ E. Computing Tax Due/§11.32 1. Tax Rate Schedules

E. Computing Tax Due

§11.32 1. Tax Rate Schedules

The tax rate structure applicable to estates and trusts is greatly compressed, placing estates and trusts into the highest tax bracket at a relatively low level of taxable income. The federal tax brackets for estates and trusts (IRC §1(e)) are adjusted annually for inflation. IRC §1(f). The rates applicable for tax years beginning in 2010 are as follows (Rev Proc 2009-50, 2009-45 Int Rev Bull 617):

Taxable Income	*Tax Rate*
$0 to $2300	15 percent
$2300 to $5350	$345 plus 25 percent of amount over $2300
$5350 to $8200	$1107.50 plus 28 percent of amount over $5350
$8200 to $11,200	$1905.50 plus 33 percent of amount over $8200
over $11,200	$2895.50 plus 35 percent of amount over $11,200

The California tax rates on trusts and estates for 2009 (rates for 2010 not yet available), as temporarily increased by 0.25 percent in each bracket, were as follows (Rev & T C §17041(e), adopting the individual rates at Rev & T C §17041(a), as adjusted for inflation per Rev & T C §17041(h)(1)):

Taxable Income	*Tax Rate*
$0 to $7060	1.25 percent
$7060 to $16,739	$88.25 plus 2.25 percent of amount over $7060
$16,739 to $26,419	$306.03 plus 4.25 percent of amount over $16,739
$26,419 to $36,675	$717.43 plus 6.25 percent of amount over $26,419
$36,675 to $46,349	$1,358.43 plus 8.25 percent of amount over $36,675
over $46,349	$2,156.54 plus 9.55 percent of amount over $46,349

There is an additional 1-percent tax on income in excess of $1 million. Rev & T C §17043. These rates apply to all taxable income, including capital gains.

NOTE: The California tax brackets, as adjusted for inflation in 2009, are lower than in 2008 because the adjustment factor for the measuring period was negative. The federal tax brackets as adjusted for inflation in 2009 were higher than in 2008, and the brackets are slightly higher still in 2010, because a different measuring period was used to calculate the adjustment factor.

With respect to sales or exchanges of capital assets held for more than 1 year, the maximum federal income tax rate on capital gains is 15 percent. The maximum rate for taxpayers in the 10- or 15-percent tax bracket is 0 percent for tax years beginning after 2007. IRC §1(h)(1)(B)-(C). The long-term capital gains tax rates also apply to qualified dividends. IRC §1(h)(11). Gain on the sale or exchange of depreciable real estate, to the extent attributable to depreciation allowed the transferor not recaptured under IRC §1250, is taxed at a maximum rate of 25 percent. IRC §1(h)(1)(D). These capital gains rates apply for purposes of the alternative minimum tax. IRC §55(b)(3). See §§11.48-11.51.

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§11.33 2. Effect of Tax Rate Schedules on Trust Distribution and Investment Strategies

The unearned income of a child under age 19 (age 24 in the case of a dependent student) is taxed at the parent's highest marginal rate (known as the "kiddie tax") to the extent that unearned income exceeds an inflation-adjusted amount equal to $1900 per year in 2010. See IRC §§1(g), 152(c)(3). For the kiddie tax to apply, the child must not have filed a joint return with a spouse. IRC §1(g)(2)(C). Unearned income of older children, and all earned income, is still taxed at the child's rates.

If the trustee has the choice of accumulating income within the trust or paying it to a beneficiary who is a child aged 19 or older, a tax savings may result from distributing income to the child, provided the child is in a lower tax bracket than the trust. In any event, the possibility of a tax savings is one factor that a trustee should consider in determining whether a distribution is appropriate.

In some instances, some benefit may be derived from funding the trust with assets that will not produce taxable income while the child is still under 19 years of age. These assets might include:

- *United States Savings (EE) Bonds*. Interest accrues until maturity. Series EE bonds are exempt from the recognition of accrued-income rules stated in IRC §1272. See IRC §1272(a)(2)(B). Thus, accrued income accumulates tax-free until the bond matures or an election is made under IRC §454(a). Maturities can be timed to occur after the child reaches age 19.
- *Growth Stocks*. Low- or no-dividend-paying stocks produce little or no income during the holding period. If the primary investment return is through appreciation, and if sale of the stock occurs after the child reaches age 19, the tax effect on a child's unearned income is mitigated.
- *Municipal Bonds*. Because municipal bonds do not produce taxable income, such income would be exempt from taxation.

A transfer by an individual to a trust of his or her assets and right to income in exchange for beneficial enjoyment of the assets and income, sometimes called a family estate trust, is not recognized for tax purposes. The income of such a trust is taxed to the grantor. A pre-need funeral trust, however, is not treated as a grantor trust. See IRC §685.

PRACTICE TIP: The trustee may have a duty to cooperate with the beneficiary to determine the best steps to reduce the combined tax obligations of the trust and the beneficiary. A review of the trust document may provide guidance.

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§11.34 3. Credits Against Tax

A trust is allowed most of the same credits against tax that are allowed on individual tax returns, subject to some additional rules. The credits most commonly used by a trust are the foreign tax credit (IRC §642(a)) and the general business credit (IRC §38). These credits are available to the trust only to the extent they are not properly allocable to the beneficiaries because of distributions made to them.

The foreign tax credit is computed on IRS Form 1116, which must be attached to IRS Form 1041. The fiduciary's share of the credit is reduced by any amount properly allocable to beneficiaries (including charitable beneficiaries). IRC §642(a).

The general business credit (IRC §38) is a combination of the investment tax credit, work opportunity credit, alcohol fuels credit, research credit, low-income housing credit, enhanced oil recovery credit, disabled access credit allowed to eligible small businesses, renewable electricity production credit, empowerment zone employment credit, Indian employment credit, employer social security credit, orphan drug credit, new markets tax credit, small employer pension plan startup cost credit, employer-provided child care credit, and various other credits. IRC §38(b).

The general business credit is allocated between the trust and the beneficiaries in the same percentage as income is allocated. See, *e.g.*, Treas Reg §1.48-6. The beneficiary's share of these credits is computed and shown on the beneficiary's Schedule K-1 of IRS Form 1041.

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§11.35 4. Alternative Minimum Tax

If a trust has any tax-preference items (described in IRC §57) or an adjusted gross income of more than $22,500, it may be liable for the alternative minimum tax (AMT). See IRC §55. To the extent that alternative minimum taxable income does not flow through to the beneficiaries, the trust must be concerned with that tax. The AMT on trusts is now computed on Schedule I of IRS Form 1041.

As its name implies, this tax is imposed as an alternative to the regular tax. It is imposed only if it would result in a tax greater than the tax computed under the standard tax rate schedules. In addition, the trustee must report each beneficiary's share of trust income for AMT purposes on the beneficiaries. See generally IRC §§55-58. The California alternative minimum tax is imposed at a rate of 7.25 percent in 2009 on the trust's alternative minimum taxable income in excess of $59,114, computed with certain state adjustments. See Rev & T C §§17062-17063.

The base on which the alternative minimum tax is computed is called the alternative minimum taxable income (AMTI). To compute AMTI, the taxable income of the trust is first adjusted as provided in IRC §§56 and 58 (for items such as depreciation, mining and development costs, interest, farm losses, and passive-activity losses). For purposes of the AMTI computation, miscellaneous itemized deductions in excess of the 2-percent floor are disallowed, but trust expenses that are not subject to the 2-percent floor under IRC §67(e) are allowed. See §11.21. Then, tax preference items under IRC §57 (such as depletion, tax-exempt interest, and intangible drilling costs) are added. IRC §55(b)(2). The first $22,500 (reduced by 25 percent of the amount by which AMTI exceeds $75,000) of AMTI is exempt from the AMT. IRC §55(d). Any remaining AMTI is taxed at a rate of 26 percent of the first $175,000 over the exemption amount, and 28 percent of the amount over $175,000. Then the AMT foreign tax credit is subtracted. IRC §55(b)(1)(A).

AMT that is net capital gain, however, is taxed at the maximum capital gains rates under IRC §55(b)(3). See §11.32.

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F. Treatment of Distributions to Beneficiaries

1. Taxation of Beneficiaries of a Simple Trust

§11.36 a. Simple Trust Defined

A simple trust is one in which the governing instrument provides that all of the trust's income is required to be distributed currently and does not require any distributions of principal or provide that any amounts are to be paid, permanently set aside, or used for charitable purposes. Treas Reg §§1.651(a)-1—1.651(a)-2. A trust will not be a simple trust in any year that it in fact distributes corpus. See Treas Reg §1.651(a)-3. Thus, a trust can switch from a simple trust to a complex trust in different years.

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§11.37 b. Beneficiary's Reportable Income

Because the income beneficiaries of a simple trust are required to receive the trust's income, those beneficiaries must include in their gross income the lesser of fiduciary accounting income (FAI) or distributable net income (DNI) (reduced by net tax-exempt income) whether or not the income is actually distributed by the trust. IRC §652(a).

The beneficiary must report this income currently, even if there is an unresolved dispute as to whether or not he or she has a right to receive the income. See IRC §652(a); Rev Rul 62-147, 1962-2 Cum Bull 151.

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§11.38 c. Character of Income

The amount included in the beneficiary's gross income has the same character in the hands of the beneficiary as in the hands of the trust. IRC §652(b). This means that items of income included in DNI, such as rental income, dividends, tax-exempt interest, and capital gains, retain their special character. A beneficiary is treated as receiving his or her prorata share of these net items in DNI. IRC §652(b). For example, assume DNI consists of net rental income (60 percent) and net tax-exempt interest (40 percent) and there is only one beneficiary. If FAI is less than DNI, the beneficiary will be treated as receiving 60 percent of the FAI as net rental income and 40 percent as net tax-exempt interest. If FAI exceeds DNI, the beneficiary will be treated as receiving 60 percent of DNI as net rental income and 40 percent of DNI as net tax-exempt interest.

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§11.39 d. Character and Allocation of Deductions

The deductions taken into account in arriving at DNI must be allocated among the various items of income comprising DNI. IRC §652(b). This will determine the net amount of each income item in DNI. These net items will then be allocated to the beneficiaries for inclusion in their gross income. Deductions directly attributable to a specific class of income are allocated to that class. Unless the trust instrument provides otherwise, to the extent that those deductions exceed DNI, the trustee may allocate the deduction in any way he or she wishes. The same is true for deductions (except deductions for tax-exempt income) that are not directly attributable to a specific class of income (such as trustee's commissions). See Treas Reg §§1.652(b)-1—1.652(b)-3.

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§11.40 e. Allocation of Income

If there is more than one income beneficiary, the income comprising DNI must be apportioned between or among them. If local law or the terms of the trust requires that different classes of trust income be allocated to different beneficiaries, then the allocation will be effective for determining the character of the income in the hands of the beneficiary. Unless local law or the trust instrument contains a specific binding allocation, classes of income will be allocated to the beneficiaries in proportion to their inclusion in DNI. Treas Reg §1.652(b)-2. The amount of DNI prorated to a beneficiary is a fraction of the trust's DNI. That fraction is the amount of FAI distributable to the particular beneficiary, divided by the total amount of FAI required to be distributed to all beneficiaries.

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2. Taxation of Beneficiaries of a Complex Trust

§11.41 a. Tier System

A trust is a complex trust in any year in which it is not a simple trust. In other words, it is a complex trust for any year in which

- The trust is not required to distribute all of its income currently;
- Amounts other than income are paid, credited, or required to be distributed; *or*
- Amounts are paid, permanently set aside, or used for the purposes specified in IRC §642(c) (relating to charitable contributions).

See Treas Reg §§1.651(a)-1, 1.661(a)-1.

When a complex trust distributes (or is required to distribute) an amount of income that is less than the amount of distributable net income (DNI), both the trust and the beneficiaries are taxed as if the trust were a simple trust in that the trust receives a deduction for all income that is distributed or is required to be distributed and the beneficiaries are taxed on all income that is distributed or is required to be distributed.

When the trust distributes (or is required to distribute) an amount of income greater than DNI, however, the excess distributions are neither taxable to the beneficiaries nor deductible by the trust. In that case, a tier system governs the deduction of the distributions by the trust and the taxation of the distributions to the beneficiaries. Gross income of a complex trust that is deductible by the trust and taxable to the beneficiaries is differentiated as first-tier or second-tier income.

First-tier income is the amount of fiduciary accounting income (FAI) required to be distributed currently to the beneficiaries (or amounts actually paid out of income that were required to be paid out of either income or corpus), whether actually distributed or not. IRC §661(a)(1). These distributions are the first distributions to be taxed to beneficiaries entitled to receive them (first-tier beneficiaries) and carry out DNI first, dollar for dollar. See §11.42.

Second-tier income is all other sums properly paid or credited or required to be distributed for that taxable year. IRC §661(a)(2). Second-tier distributions are distributions of second-tier income. These carry out any DNI remaining after the first-tier distributions. If second-tier distributions exceed the remaining DNI, the remaining DNI is allocated pro rata among all second-tier beneficiaries based on the respective amounts they receive. See §11.43.

If the total distributions (or required distributions) do not exceed DNI, the tiers are irrelevant. In that case, amounts paid, credited, or required to be distributed carry out DNI dollar for dollar, each reflecting its proportionate share of the items of income and deductions in DNI, except to the extent of any special allocations. The remaining DNI is taxed to the trust. See generally IRC §§661-663; Treas Reg §§1.661(a)-1—1.663(c)-6.

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§11.42 b. First-Tier Distributions and Beneficiaries

First-tier distributions include any income required to be distributed currently and annuity payments required to be paid from income or principal, to the extent that income is available to pay these amounts. Treas Reg §1.662(a)-2. For this purpose, income is fiduciary accounting income (FAI). Income is required to be distributed currently if the will or trust requires income to be distributed at least annually, regardless of whether it is actually distributed. If an estate or trust requires a distribution which may be paid out of FAI or principal, such as annuity payments, it is treated as a required distribution of income to the extent it is paid out of FAI.

First-tier beneficiaries are beneficiaries to whom income is required to be distributed currently, but they are assigned to the first tier only to the extent of such income. See generally IRC §§661-663; Treas Reg §§1.661(a)-1—1.663(c)-6.

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§11.43 c. Second-Tier Distributions and Beneficiaries

Second-tier distributions are amounts other than income required to be distributed currently and annuities paid out of income. Examples of second-tier distributions include

- Discretionary distributions of income or principal;
- Mandatory distributions of principal, such as annuity payments paid or required to be paid out of principal;
- In-kind distributions of property; and
- Mandatory distributions on the occurrence of an event specified in the trust instrument.

See Treas Reg §1.662(a)-3(b).

To qualify as a second-tier distribution, the distribution must be properly paid, credited, or required to be distributed currently. A distribution is properly paid if it is made in accordance with the provisions of state law or the governing trust instrument. See Rev Rul 71-335, 1971-2 Cum Bull 250. Amounts are properly credited to a beneficiary if they are "irrevocably and unconditionally placed at the disposal of the beneficiary." *Grant v Nicholas* (D Colo 1955) 127 F Supp 236, 241.

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§11.44 d. Taxation of Distributions

Under IRC §662(a), required distributions of income (first-tier distributions) are taxed to the beneficiaries to whom they are payable to the extent of DNI. Each such beneficiary pays tax on the income to the extent of his or her proportionate share of DNI, whether or not received. If DNI exceeds the first-tier distributions, second-tier distributions are taxed to the beneficiaries to whom they are payable to the extent of any remaining DNI. Any DNI that is not allocated to either first-tier or second-tier beneficiaries is taxed to the trust because the trust does not receive a distribution deduction for such remaining DNI. Distributions in excess of DNI are not taxable to the beneficiaries. See Treas Reg §§1.662(a)-1—1.662(a)-3.

The total distributions may be less than, equal to, or greater than DNI. If the total distributions are less than DNI, then each distribution carries out DNI up to the value of the distribution, with the remaining DNI taxed to the estate or trust. DNI is allocated first to the first-tier distributions, and the remaining DNI, if any, is allocated to the second-tier distributions.

When first-tier distributions equal or exceed DNI, the beneficiary has taxable income to the extent of his or her proportionate share of DNI, and the balance of the first-tier distribution, as well as any second-tier distributions, are not taxable to the beneficiaries. The result for the first-tier beneficiaries is thus the same as if the trust were a simple trust and had not made any second-tier distributions.

When total first-tier and second-tier distributions are less than DNI, both first-tier and second-tier distributions are taxable to the beneficiaries. When first-tier distributions are less than DNI and total first-tier and second-tier distributions exceed DNI, then the first-tier distributions will be taxable to the first-tier beneficiaries. A pro rata portion of the second-tier distributions will carry out the remaining DNI and will be taxable to the second-tier beneficiaries. The balance of the second-tier distributions will not be taxed to the beneficiaries.

When all distributions are second-tier distributions, each distribution carries out its proportionate share of DNI. If the total second-tier distributions are less than DNI, a portion of the DNI is carried out to the beneficiaries, up to the respective values of the distributions, and the beneficiaries are taxed on that income. The balance is treated as remaining in the estate or trust. If distributions exceed DNI, the portion of the distributions exceeding DNI will not be taxable to the beneficiary.

The amount included in the second-tier beneficiary's gross income is the amount that bears the same ratio to DNI (reduced by the amounts of income required to be distributed currently to all beneficiaries) as the amount of the second-tier beneficiary's distributions bears to the total amount of all second-tier beneficiaries' distributions.

For complex trusts, distributions of specific sums of money or specific property required to be paid in no more than three installments are not considered second-tier distributions and are not taxable to the beneficiary (under IRC §§663 and 102) because they qualify as gifts or devises. These do not carry out DNI of an estate or trust.

If a complex trust is required to distribute all of its income currently, the required income distribution will consume DNI first. The beneficiaries of any principal or discretionary income will have gross income from their distributions only to the extent DNI exceeds the required income distribution, subject to the income characterization rules. Thus, first-tier beneficiaries of complex trusts are treated similarly to the beneficiaries of simple trusts. See generally IRC §§661-663; Treas Reg §§1.661(a)-1—1.663(c)-6.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.45 e. Character of Income and Deductions

§11.45 e. Character of Income and Deductions

Items of income and deductions must be allocated to each beneficiary in proportion to their respective share of DNI, unless the trust or state law requires a different allocation. IRC §662(b).

Expenses directly attributable to a specific class of income are allocated to that specific class. Indirect expenses may be allocated in the trustee's discretion to one or more classes of income. Treas Reg §1.652(b)-3.

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§11.46 f. Separate Share Rule

For purposes of computing distributable net income for complex trusts under IRC §§661-662, if a single trust has more than one beneficiary with shares substantially separate and independent from those of other beneficiaries, the shares are treated as separate trusts. IRC §663(c). This treatment avoids the taxation of one beneficiary on income accumulated for another beneficiary. See Treas Reg §1.663(c)-1. Those shares are not treated as separate for any purpose other than determining distributable net income in calculating the distribution deduction, and it is not necessary or appropriate to file separate tax returns, maintain separate accounts, or segregate assets for each separate share. See Treas Reg §§1.663(c)-1(b)—1.663(c)-1(c). See also §11.12 on the effect of failing to distinguish between a trust with separate shares treated as separate trusts and true separate trusts.

The separate share rule does not apply to a single trust instrument that creates several trusts—which does require the filing of separate tax returns for each of these separate trusts (Treas Reg §1.663(c)-1(a))—or to trusts that provide for successive interests (see Treas Reg §1.663(c)-3(e)).

The separate-share rule does, however, apply to a decedent's revocable trust during the period of administration before the trust is divided into subtrusts such as a marital trust, a credit shelter trust, and a survivor's trust. Treas Reg §1.663(c)-4(a). The separate-share rule also applies to the division of the residue of a revocable trust into separate shares for children at death. Treas Reg §1.663(c)-3(a).

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§11.47 3. Other Beneficiary Taxation Issues

The amount of trust income that beneficiaries report on their personal income tax returns is based on the trust's distributable net income for its year or years ending with or within the beneficiaries' tax year. IRC §§652(c), 662(c). If a beneficiary is a fiscal-year taxpayer, the beneficiary includes in his or her income for each year the beneficiary's share of trust income earned by the trust through December 31 of the previous year.

The trustee must furnish each beneficiary with a Schedule K-1 of IRS Form 1041 that provides the tax information necessary for the beneficiary to prepare his or her personal income tax returns, or a substitute form prepared by the fiduciary that furnishes this information.

The beneficiary's tax return must be consistent with the estate or trust tax return, or the beneficiary must file a statement identifying the inconsistency. IRC §6034A(c).

NOTE: If the beneficiary is a nonresident of California, there still may be a California tax on California source income, which would require that the beneficiary file a California income tax return. Rev & T C §17041. The trustee must withhold tax on payments of income from California sources to nonresident beneficiaries that are not subject to payroll withholding. See §11.59.

If a foreign trust has received property from a United States transferor, the foreign trust is treated as having a United States beneficiary unless no trust income or corpus is directly or indirectly paid to a United States person, and if the trust is terminated, no income or corpus could be paid to, or for the benefit of, a United States person. Treas Reg §1.679-2.

PRACTICE TIP: If the trustee will be unable to file timely returns and is granted an extension to file, the trustee should notify the beneficiaries of the delay so that they can also seek extensions to file their own returns.

NOTE: If property is transferred to a foreign trust, the person who transfers property (and not the beneficiary) has to recognize gain unless the transfer is to a grantor trust, a charitable trust, or any other applicable exception. See Treas Reg §§1.684-1, 1.684-3.

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§11.48 G. Capital Gains and Losses

A trust will realize gross income when it sells, exchanges, or otherwise disposes of property for an amount in excess of its adjusted basis in the property. IRC §§61(a)(3), 1001(a). See §11.49. A taxable disposition may also occur when an asset is distributed in kind to a beneficiary or creditor. See §11.50. Capital gains and losses are reported on Schedule D of IRS Form 1041.

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§11.49 1. When Gains and Losses on Sale of Capital Asset by Trust Included in DNI

In general, when a capital asset is sold or exchanged and gain is realized, the gain is principal and is retained in the trust, and the trust recognizes and pays tax on the gain. If losses are realized, the trust may deduct them up to the aggregate gains recognized plus $3000 in excess of such gains. IRC §1211(b). Any losses that are not deductible in the year incurred may be carried forward for an unlimited number of years until used. IRC §1212(b). See §11.50 regarding circumstances in which in-kind distributions of trust property may require the trust to recognize capital gain.

Generally, the gain or loss is not included in distributable net income (DNI) because capital gains and losses are allocated to principal and affect the remainder beneficiaries of the trust. See IRC §643(a)(3); Treas Reg §1.643(a)-3(a). Thus, the income beneficiary is not taxable on the gain and does not get the benefit of the loss. Even if capital gains and losses are not included in the computation of DNI, state income tax attributable to the gain is deductible for purposes of determining DNI. Rev Rul 74-257, 1974-1 Cum Bull 153.

In exceptional cases, however, the gain on sale is included in DNI and paid out to the beneficiary. When that happens, the beneficiary recognizes the gain and pays the tax on it. In these cases, capital losses that reduce net capital gains are in effect included in DNI. Conversely, net capital gains included in DNI may permit beneficiaries to deduct their own capital losses. The exceptions are as follows:

- Gains allocated to fiduciary accounting income under local law or the trust instrument. See §11.49A.
- Gains actually distributed to a beneficiary. See §11.49B.
- Gains that are paid, permanently set aside, or to be used for charitable purposes. See §11.49C.
- Gains allocated to principal but consistently treated as distributed to a beneficiary. See §11.49D.
- Short-term gains resulting from mutual fund distributions. See IRS Letter Rulings 9811036, 9811037.
- Gains used to determine the amount of the distribution. Treas Reg §1.643(a)-3(b)(3). This is a very limited exception. For an illustration, see Treas Reg §1.643(a)-3(e), Example 6.
- Gains incurred in the year of termination of the trust. See IRC §643(a)(3); Treas Reg §1.643(a)-3(e), Examples 9-10. See also §11.51.

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§11.49A a. Gains Allocated to Income Under Local Law or Trust Instrument

Gains that are allocated to fiduciary accounting income under local law or the trust instrument or pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with a power granted by applicable local law or by the governing instrument if not prohibited by applicable local law are included in DNI. Treas Reg §1.643(a)-3(b)(1). Treasury Regulation §1.643(b)-1 provides, however, that "[t]rust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." Notwithstanding this rule, the regulation provides that "an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust" and that "a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust." Treas Reg §1.643(b)-1.

The California Uniform Principal and Income Act (UPAIA) provides that money or other property received from the sale or exchange of an asset should be allocated to principal. Prob C §16355. The UPAIA also provides, however, that the trust instrument may specify a different allocation and may give the trustee discretion to allocate items to income or principal. Prob C §16335. In addition, it provides that the trustee may recharacterize principal as income under certain circumstances. Prob C §16336. Further, a trustee may—again, under certain circumstances—be allowed to convert a traditional income trust to a unitrust (or reconvert from a unitrust to an income trust), as permitted by the definition of "income" in Treas Reg §1.643(b)-1, without obtaining a court order. Prob C §§16336.4-16336.7. See §§8.3A-8.3F. In light of the flexibility inherent in California law, it seems unlikely that a trust provision allocating gains and losses to income or authorizing a trustee to make such an allocation would be treated as departing fundamentally from traditional principles of income and principal. See Treas Reg §1.643(a)-3(e), Examples 4-5.

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§11.49B b. Gains Actually Distributed to Beneficiary

Gains that are actually distributed to a beneficiary during the taxable year are included in DNI. IRC §643(a)(3); Treas Reg §1.643(a)-3(b)(3). The trustee must allocate the capital gain to the beneficiary pursuant to the trust instrument or state law or pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with a power granted by applicable local law or by the governing instrument if not prohibited by applicable local law, and the distribution generally must be required by the trust instrument upon the occurrence of a specific event. See Treas Reg §1.643(a)-3(e), Examples 7-8.

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§11.49C c. Gains Paid, Permanently Set Aside, or to Be Used for Charitable Purposes

Gains that are paid, permanently set aside, or to be used for charitable purposes are included in DNI. IRC §643(a)(3); Treas Reg §1.643(a)-3(c). Gains will not be considered permanently set aside for a charitable purpose unless, under the terms of the governing instrument and the circumstances of the case, the possibility that they will not be devoted to such purpose is so remote as to be negligible. IRC §642(c); Treas Reg §1.642(c)-2(d). In *Samuel P. Hunt Trust v U.S.* (D NH 2003) 2005-1 USTC ¶50,357, 93 AFTR2d 351, for example, the court held that charitable remainder trust gains were not permanently set aside for charitable purposes because the trustee had the power to allocate capital gains to income.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.49D d. Gains Consistently Treated as Distributed to Beneficiary

§11.49D d. Gains Consistently Treated as Distributed to Beneficiary

Gains that are allocated to principal but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary are included in DNI. Treas Reg §1.643(a)-3(b)(2). When a practice is established of using gains to determine the amount of the distribution to the beneficiaries and the gains are actually distributed to the beneficiaries, the gains will be included in DNI. Once established, however, the practice must be followed in future years. See Treas Reg §1.643(a)-3(e), Examples 1-3.

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§11.50 2. When Gain or Loss on In-Kind Distributions Recognized by Trust

Ordinarily, a trust will not recognize gain or loss on an in-kind distribution of property to a beneficiary. The trust will, however, recognize gain or loss on an in-kind distribution if (1) the distribution is in satisfaction of the beneficiary's right to receive a specific dollar amount, specific property other than the property distributed, or trust accounting income (Treas Reg §1.661(a)-2(f); see *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217) or (2) the trustee makes an election under IRC §643(e). In such cases, the trust pays the tax on the gain, and the gain will generally not be included in DNI unless it is allocated to income.

A trustee of a trust and the trust's beneficiary are considered related taxpayers under IRC §267(b)(6). As a general rule, therefore, no loss is recognized on an in-kind distribution to a beneficiary, and if the beneficiary subsequently sells the property at a gain, he or she receives a dollar-for-dollar credit against the gain up to the amount of the loss that the trust realized on distribution. Loss may be recognized by a trust, however, when the trustee has made an election under IRC §645 to treat the trust as part of the decedent's estate for fiduciary income tax purposes, because such losses may be recognized in estates. IRC §267(b)(13). See §11.53.

When a discretionary in-kind distribution is made to a second-tier beneficiary, whether or not in lieu of a right to receive a specific dollar amount, specific property other than the property distributed, or trust accounting income, the trust may elect to recognize any gain and pay the tax. IRC §643(e)(3). If the election is made, the amount of the second-tier distribution will equal the fair market value of the property. IRC §643(e)(3)(A). If the election is not made, the amount of the second-tier distribution will equal the lesser of the fair market value and the adjusted basis of the property including any gain or loss recognized by the trust on the distribution. IRC §643(e)(1)-(2). The beneficiary's basis in the property will be the trust's adjusted basis, adjusted for any gain or loss recognized by the trust. Thus, if no election is made, the beneficiary's basis will be the trust's basis and gain will not be realized until the beneficiary sells or exchanges the property.

Typically, therefore, the trust will not make the election unless it has losses or deductions that can be used to reduce or eliminate the gain. If the election under IRC §643(e)(3) is made, it applies to all distributions made by the trust during that taxable year. The election is made by the trust on its return for the taxable year in which the distribution is made and, once made, can be revoked only with the consent of the Secretary of the Treasury. IRC §643(e)(3)(B).

Capital gains treatment is not permitted to the extent that gain on an in-kind distribution to a beneficiary is attributable to depreciation allowed the trust. IRC §1239(a), (b)(2)-(3). Such gain must be treated as ordinary income.

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§11.51 3. Gain or Loss Passed Through to Beneficiary in Distributions on Termination of Trust

In the year a trust terminates, capital gains and losses are passed through to the beneficiaries "succeeding to the property." IRC §642(h). These beneficiaries recognize the gain and may deduct the losses, including carry-over losses. Any limitation on deducting capital losses is determined individually for each beneficiary based on the beneficiary's adjusted gross income for the year. Accordingly, all capital gains are included in DNI and all capital losses (up to the amount of gains) are taken into account in computing DNI. See IRC §643(a)(3).

The regulations define beneficiaries who succeed to the property as the beneficiaries who "bear the burden" of the loss. Treas Reg §1.642(h)-3. In other words, the deduction may be taken by the beneficiary who receives a smaller distribution because of the loss. In many cases, this will be the remainder or residuary beneficiary. Thus, beneficiaries who receive termination distributions that represent specific dollar amounts or specific property do not recognize the gain or deduct the loss unless the loss results in the beneficiary receiving less than the beneficiary would otherwise have received.

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§11.52 H. Taxable Year of Trust

Generally, all trusts other than tax-exempt trusts (such as qualified plan trusts or charitable trusts) are required to use the calendar year for tax reporting purposes. IRC §644. However, exceptions apply when the trustee makes an IRC §645 election (see §§11.53-11.53C) or an IRC §663(b) 65-day election (see §11.54).

California generally follows the federal rules regarding both accounting periods and methods of accounting by incorporating the federal law (IRC §§441-483) in the California statutes. Rev & T C §17551. See Rev & T C §§17552-17570 for exceptions. Unless specifically provided otherwise by the Revenue and Taxation Code and noted in the discussion, all information below applies equally for California purposes.

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§11.53 1. IRC §645 Election

For estates of decedents dying after August 5, 1997, IRC §645 permits the trustee of a deceased settlor's "qualified revocable trust" and the executor of the settlor's estate to elect to treat the trust as part of the estate for fiduciary income tax purposes. Unlike a trust, an estate may use a fiscal year other than the calendar year. IRC §441(b); Treas Reg §1.441-1(c). If an election is made under IRC §645 to use a fiscal year for the trust, the estate's fiscal year will also be the trust's tax year. A qualified revocable trust is one that was treated as owned by the settlor for income tax purposes under IRC §676. IRC §645(b)(1).

NOTE: Even if substantially all assets are in the revocable trust at the decedent's death and there is no probate estate, the election may still be made.

If the IRC §645 election is made, the election is effective with respect to tax years ending after the settlor's date of death and before (1) the second anniversary of the settlor's date of death or (2) if an estate tax return is required, 6 months after the date of final determination of the estate tax liability. IRC §645(b)(2). The election must be made by the original due date of the estate's first fiduciary income tax return. Once made, the election is irrevocable. IRC §645(c). On planning opportunities using the election, see §11.53A. On the procedure for making the election, see §11.53B.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.53A a. Planning Opportunities Using IRC §645 Election

§11.53A a. Planning Opportunities Using IRC §645 Election

Electing to treat the deceased settlor's revocable trust as part of the settlor's estate under IRC §645 presents significant planning opportunities:

- The election can reduce the number of post-death tax returns by reducing the number of post-death tax years of administration.
- A fiscal year can defer a beneficiary's income into a later calendar year.
- The election allows the deductions of one entity to be used to offset the income of the other and may allow the trust to deduct passive losses.
- The election may avoid the need to make estimated tax payments for the trust.

However, because the fiduciary income tax rate brackets are very compressed, a careful analysis should be made before making the election if the trust and estate both have income or capital gains that will not be distributed.

PRACTICE TIP: Before a §645 election is made, it may be necessary to forecast the tax results over the next 3 years, including the year when the election is no longer applicable.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.53B b. Procedure for Making IRC §645 Election

§11.53B b. Procedure for Making IRC §645 Election

If there is an executor, the following steps must be taken (Treas Reg §1.645-1(c)(1)): The trustee of the trust and the executor of the estate must make an election to treat the trust as part of the estate. To do this, the trustee and executor file an Election to Treat a Qualified Revocable Trust as Part of an Estate (IRS Form 8855). See §11.53C for form.

For the election to be valid, the election must be filed no later than the time prescribed under IRC §6072 for filing IRS Form 1041 for the first taxable year of the combined electing trust and related estate. The executor must file a complete IRS Form 1041 for the combined estate and trust for each taxable year during the election period. The trustee must provide the executor with all trust information necessary to enable the executor to file IRS Form 1041.

If there is no executor, the following steps must be taken (Treas Reg §1.645-1(c)(2)): The trustee must make the election by filing IRS Form 8855. The election must be made by the time prescribed under IRC §6072 for filing IRS Form 1041 for the first taxable year of the electing trust.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.53C c. Form: Election to Treat a Qualified Revocable Trust as Part of an Estate (IRS Form 8855)

§11.53C c. Form: Election to Treat a Qualified Revocable Trust as Part of an Estate (IRS Form 8855)



Form **8855**
(Rev. January 2009)

Department of the Treasury
Internal Revenue Service

Election To Treat a Qualified Revocable Trust as Part of an Estate

OMB No. 1545-1881

Part I Estate (or Filing Trust) Information

Name of estate (or the filing trust, if applicable (see instructions))	**Employer identification number** (see instructions)
Name of executor (or the filing trustee, if applicable)	Type of entity prior to the election: ☐ Domestic estate ☐ Foreign estate
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	☐ Domestic trust ☐ Foreign trust
City or town, state, and ZIP code (if a foreign address, see instructions)	Date of executor's appointment

Under penalties of perjury, I, as executor (or filing trustee):

- Confirm that under applicable local law or the governing document, I have the authority to make this election for the estate (if executor) or trust (if filing trustee) and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for the above-named estate (or filing trust, if applicable);
- Confirm that an agreement has been reached with the trustees of each qualified revocable trust (QRT) joining in the election to allocate the tax burden of the combined electing trusts and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that the related estate's (or filing trust's, if applicable) share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Agree to accept responsibility for filing a complete, accurate, and timely income tax return, when required by law, for the combined electing trust(s) and related estate, if any, for each tax year during the election period;
- (If I am the filing trustee) confirm that if there is more than one QRT making this election, that I have been appointed by the trustees of each QRT making this election to be the filing trustee and I agree to accept the responsibility of filing the appropriate income tax return for the combined electing trust(s) for each tax year during the election period and all other responsibilities of the filing trustee;
- (If I am the filing trustee) represent that no executor has been appointed for a related estate and to the best of my knowledge and belief, one will not be appointed;
- (If I am the filing trustee) agree that, if an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the late appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of executor (or filing trustee)	Date

Part II Decedent Information

Name of decedent	SSN of the decedent	Date of death

Part III Qualified Revocable Trust Information

Name of trust | Employer identification number (see instructions)

Name of trustee

Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)

City or town, state, and ZIP code (if a foreign address, see instructions)

Under penalties of perjury, I, as trustee of the above-named trust:

- Confirm that under applicable local law or the governing instrument, I have the authority to make this election for the trust and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for this trust;
- Agree to timely provide the executor (or filing trustee if there is no executor) with all the trust information necessary to permit the executor (or filing trustee, if applicable) to file a complete, accurate, and timely Form 1041 (or Form 1040-NR for a foreign estate) for the combined electing trust(s) and the related estate, if any, for each tax year during the election period;
- Confirm that an agreement has been reached with the trustees of each QRT joining in the election, and the executor of the related estate, if any, to allocate the tax burden of the combined electing trust(s) and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that this trust's share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Confirm that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855, the trustee that completed Part I has been appointed the filing trustee, and to the best of my knowledge and belief, an executor has not been appointed to administer a related estate and one will not be appointed;
- Agree that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855 and an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the later appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information of the electing trust contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of trustee | Date

Name of trust | Employer identification number (see instructions)

Name of trustee

Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)

City or town, state, and ZIP code (if a foreign address, see instructions)

Under penalties of perjury, I, as trustee of the above-named trust:

- Confirm that under applicable local law or the governing instrument, I have the authority to make this election for the trust and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for this trust;
- Agree to timely provide the executor (or filing trustee if there is no executor) with all the trust information necessary to permit the executor (or filing trustee, if applicable) to file a complete, accurate, and timely Form 1041 (or Form 1040-NR for a foreign estate) for the combined electing trust(s) and the related estate, if any, for each tax year during the election period;
- Confirm that an agreement has been reached with the trustees of each QRT joining in the election, and the executor of the related estate, if any, to allocate the tax burden of the combined electing trust(s) and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that this trust's share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Confirm that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855, the trustee that completed Part I has been appointed the filing trustee, and to the best of my knowledge and belief, an executor has not been appointed to administer a related estate and one will not be appointed;
- Agree that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855 and an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the later appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information of the electing trust contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of trustee | Date

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§11.54 2. IRC §663(b) 65-Day Election

The trustee may elect to treat all or part of a distribution to any beneficiary made up to 65 days after the close of the trust's tax year as a distribution on the last day of that tax year. IRC §663(b). This rule recognizes that many trusts annually distribute all current income and need a reasonable time after the end of the calendar year to compute and distribute the correct amount of income. Generally, the election must be made on a timely filed tax return for the year. In IRS Letter Ruling 200617015, the IRS granted the trustee an extension of time to make the election under Treas Reg §301.9100-3. The election applies only to the extent that the distribution does not exceed the greater of the trust's income or distributable net income, taking into account other amounts distributed during the year to which the election relates. IRC §663(b); Treas Reg §1.663(b)-1(a)(2). The executor of an estate may also elect to treat all or part of a distribution paid up to 65 days after the close of the estate's tax year as a distribution on the last day of that tax year. IRC §663(b). This is important for trustees who elect to treat a qualified revocable trust as part of the decedent's estate for federal income tax purposes under IRC §645.

PRACTICE TIP: If the executor or trustee intends to make an IRC §663(b) election, notice should be provided to the beneficiary for his or her own tax planning.

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§11.55 I. Final Fiduciary Returns

A trust is recognized as a taxable entity only until the trust property has been distributed to the successors and for a reasonable time thereafter to wrap up the administration of the trust. See Treas Reg §1.641(b)-3(a), (b).

The trustee must file final fiduciary returns on the termination of a trust. The trust pays no tax on the final return because all income flows to the distributees. Any gains or losses incurred in the year of termination are also passed through to the beneficiaries. Treas Reg §1.641(b)-3(d). See also IRC §§642(h), 643. Once an estate or trust is considered terminated for tax purposes, the gross income, credits, and deductions of the estate or trust subsequent to termination are considered to be the gross income, credits, or deductions of the successors to the property. See Treas Reg §1.641(b)-3(d).

Internal Revenue Service Form 56 (Notice Concerning Fiduciary Relationship) may be used to notify the IRS of the termination of the fiduciary relationship. See §11.9 for form. California does not have an equivalent form, but the Franchise Tax Board accepts IRS Form 56. See FTB Publication 1006. Filing procedures are discussed in §11.8.

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§11.56 J. Trapped Income: Trust Accounting Income Versus Taxable Income of the Trust

A trust's taxable income is rarely the same as the trust's income for trust accounting purposes under local law. For example, gain from the sale of trust property is certainly "income" for tax purposes, but is normally "principal" for purposes of determining whether the trustee should pay the profit to the income beneficiary or retain it for later distribution to the remaindermen. "Trapped income" is the term used to describe the common occurrence of the receipt by the trustee of an item treated as principal for California trust law purposes but treated as income for tax purposes. Such an item would include income in respect of a decedent. For example, receipts from an individual retirement account (IRA) and from a qualified retirement plan may be treated as principal under California trust law but as income for income tax purposes. See §§8.24-8.24B.

PRACTICE TIP: The trust document should be reviewed to determine whether there are any specific directions regarding allocation of income and principal contrary to the rules contained in the California Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) or that are not covered by UPAIA. See chap 8. Trapped income commonly occurs in a complex trust.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.57 K. Special Rules Applicable to Grantor Trusts

§11.57 K. Special Rules Applicable to Grantor Trusts

In some instances, a trustor (or even more rarely, a beneficiary) has such substantial control over trust property that the person is deemed the owner of the property for tax purposes. The applicable statutes are IRC §§671-679, known as the "grantor trust rules." To the extent that any person is treated as the owner of the trust under the grantor trust rules, any item of trust income (and any related deductions and credits allocable to it) that is attributable to that person is taxable to him or her and is reportable on his or her individual income tax return (see §§11.76-11.81). IRC §671. See IRS Form 1040 (and FTB Form 540). If the trust is a grantor trust, the existence of the trust is generally ignored and the trust income is taxed to the "owner," who is also entitled to claim any deductions and credits. Treas Reg §1.671-4.

A grantor will be considered the owner of a trust (or a portion of the trust) if he or she meets any of the following criteria:

- The grantor has a reversionary interest in either the trust corpus or income exceeding 5 percent of the value of that portion of the trust measured as of the date of the "inception" (the date the property was added to the trust) of that portion of the trust, except as provided in IRC §673(b) (IRC §673);
- The grantor, a "nonadverse party" (as defined in IRC §672(b)), or both, have the power to control the beneficial enjoyment of the trust (exceptions are made for certain powers, such as a power exercisable only by will; see IRC §674(b)) (IRC §674);
- The grantor, a nonadverse party, or both have certain administrative powers over the trust's corpus or income that could be exercised for the benefit of the grantor or the grantor's spouse rather than the beneficiaries (IRC §675; see IRS Letter Ruling 200612002);
- The grantor, a nonadverse party, or both have the power to revest title to trust assets in the grantor (IRC §676); or
- The grantor, a nonadverse party, or both may cause income to be distributed to the grantor or the grantor's spouse or applied to the payment of premiums on life insurance on their lives (IRC §677).

For purposes of these criteria, the grantor is treated as holding any power or interest held by his or her spouse. IRC §672(e). All of the criteria are subject to detailed rules governing their application, as set out in the regulations to IRC §§673-677.

NOTE: The IRS has ruled that the grantor does not make a gift to the trust when the grantor pays taxes on trust income without reimbursement by the trust. If the trust is required to reimburse the grantor for taxes, the trust is included in the grantor's estate under IRC §2036 (applicable to trusts created on or after October 4, 2004), but there is no such inclusion if an independent trustee has discretionary power to reimburse the grantor. Rev Rul 2004-64, 2004-27 Int Rev Bull 7.

Among other applications, a grantor trust is frequently used for irrevocable life insurance trusts that are designed to receive annual exclusion gifts or taxable gifts from the grantor and hold life insurance on the life of the grantor. The objective of creating grantor trust status without causing the insured to have incidents of ownership that would cause inclusion of the insurance proceeds in the insured's estate under IRC §2042 is often accomplished by giving the grantor's spouse a power that is treated as held by the grantor under IRC §672(e), but not so treated for IRC §2042 purposes. The proceeds then may be used to purchase assets from the insured's revocable trust after the death of the insured to provide for payment of estate taxes. See §13.41.

Under some circumstances, a person other than the grantor can also be considered as the owner of trust property. This occurs when the person has the power to vest property in himself or herself (such as when the person holds a withdrawal right). After the power has lapsed, the person would be treated as the owner of the trust under IRC §§671-677 if he or she was the grantor of the trust.

NOTE: Generally, a beneficiary will be treated as an owner only if the grantor cannot be so treated and the beneficiary has significant control of the trust assets. IRC §678. See *Thomas B. Goldsby, Jr.*, TC Memo 2006-274, in which

the income beneficiary of a trust claimed an income tax deduction for a contribution of a conservation easement made by the trust on the basis that he had failed to take mandatory distributions of income from the trust and was therefore the grantor of the "income portion" of the trust. The court held that the beneficiary was the owner of the income portion of the trust, but failed to prove that the contribution was made from that portion.

If the grantor does not meet the described criteria, or no longer meets the criteria, the trust fiduciary must obtain a taxpayer identification number for the trust and file IRS Form 1041 (and FTB Form 541) for the income not owned by the grantor. See Treas Reg §301.6109-1(a). For those trusts, the fiduciary should follow the general filing requirements for a trust's income tax return that are outlined in §§11.61-11.66.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.57A L. Trusts Holding S Corporation Stock

§11.57A L. Trusts Holding S Corporation Stock

A trust that qualifies as an electing small business trust (ESBT) is eligible to hold stock in a subchapter S corporation. IRC §1361(c)(2)(A)(v). The portion of an ESBT that consists of S corporation stock is treated as a separate trust. IRC §641(c)(1). The federal income tax on the portion of the ESBT holding the stock is imposed at the highest marginal rate applicable to trusts and without the benefit of most deductions generally available to trusts. See IRC §641(c)(2). For example, no distribution deduction is allowed for amounts distributed to the beneficiaries with respect to the portion of the ESBT holding the S corporation stock. The income tax on this portion of the ESBT is payable by the ESBT. The portion of the ESBT that does not consist of S corporation stock is taxed in the usual manner without the foregoing adjustments or modifications. In the case of a trust that is eligible to hold S corporation stock as a qualified subchapter S trust (QSST) under IRC §1361(d), the beneficiary of the trust is treated as the owner of the trust under IRC §678(a) with respect to the S corporation stock.

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V. CALIFORNIA TRUST TAXATION RULES

§11.58 A. Taxation of Income From California Sources and Trusts With Resident Trustees or Beneficiaries

All trust income from California sources (see §11.60) is subject to California income tax regardless of the residence of the trustees or the beneficiaries. If all trustees or all current noncontingent beneficiaries are California residents, the trust is taxed on all income from all sources, both within and without California, regardless of the residence of the settlor. Rev & T C §17742(a). In some cases, this may result in double taxation of trust income. See §11.60A. The income of the trust may be taxed in California even if the only contact of the trust with California is the residence of a noncontingent beneficiary. *McCulloch v Franchise Tax Bd.* (1964) 61 C2d 186, 37 CR 636.

If, however, the trust derives income from both within and without California and has a trustee *and* a noncontingent beneficiary who are not California residents, the trustee must determine what portion of the trust's undistributed income is taxable in California. If the trust has a non-California resident beneficiary and derives income from both within and without California, the trustee must determine what portion of the income distributed to that beneficiary is taxable in California, even if all trustees are California residents. Rev & T C §17744.

If at least one trustee is a California resident and all noncontingent beneficiaries are nonresidents, the trust is taxed on all California-source income plus the proportion of all other income that the number of California resident trustees bears to the total number of trustees. Rev & T C §17743. See §11.58A.

If at least one noncontingent beneficiary is a California resident and at least one noncontingent beneficiary is a nonresident and all trustees are nonresidents, the trust is taxed on all California source-income plus the proportion of all other income that the number of California resident noncontingent beneficiaries bears to the total number of noncontingent beneficiaries. Rev & T C §17744. See §11.58B.

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§11.58A 1. Residence of Corporate Fiduciary

For purposes of California trust income taxation, the residence of a corporate fiduciary is the place where the corporation transacts the major portion of its administration of the trust. Rev & T C §17742(b). Ministerial functions such as tax return preparation and recordkeeping may be distinguished from more significant functions involving investment and distribution decisions in determining where the major portion of administration takes place. *Ronald Family Trust* (SBE, May 4, 2000) 2000 Cal Tax Lexis 205. In 1996, the Franchise Tax Board issued a letter to counsel for Wells Fargo Bank (sometimes referred to as "the O'Melveny Letter") stating that the performance of certain clerical and administrative functions in California would not cause California taxation of trusts for which non-California subsidiaries of the bank previously acted as trustees.

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§11.58B 2. Allocating Non-California Source Income

FTB Legal Ruling No. 238 (Oct. 27, 1959) 1959 Cal FTB Lexis 14, provides the following method for allocating non-California source income where there is a mixture of California resident and nonresident fiduciaries and California resident and nonresident noncontingent beneficiaries under Rev & T C §17744. See §11.58.

Assume that the total taxable income of the trust is $90,000 and is not sourced in California. There are three trustees, one of whom is a resident of California (1/3). There are two noncontingent income beneficiaries, one of whom is a resident of California (1/2). A noncontingent beneficiary or vested beneficiary is one whose interest is not subject to a condition precedent. A condition precedent is one that must happen before some right dependent thereon accrues or some act dependent thereon is performed. (Survivorship is a condition precedent.) The amount of income taxable by California is calculated in the following steps:

- Taxable income is first allocated to California by the ratio of the number of California fiduciaries to the total number of trustees. The trustee calculation is 1/3 of $90,000 = $30,000.
- The amount allocated to California in that ratio (from Step 1) is subtracted from total taxable income. The amount for the next allocation is $60,000 ($90,000 − $30,000).
- The remainder of total income is then allocated to California by the ratio of the number of California noncontingent beneficiaries to the total number of noncontingent beneficiaries. The beneficiary calculation is 1/2 of $60,000 = $30,000.
- The sum of the fiduciary calculation and the noncontingent beneficiary calculation is the amount of non-California source income taxable by California. The fiduciary income calculation of $30,000 plus the beneficiary income calculation of $30,000 equals the income taxable by California of $60,000.

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§11.59 B. Taxation of Resident Beneficiary

Subject to the general rules of taxability described in §§11.13-11.57, income that is distributed to a beneficiary (whether vested or contingent) who is a resident of California is taxable to that beneficiary. The tax attributable to the inclusion of that income in the gross income of that beneficiary for the year in which income is distributed to a resident contingent beneficiary is the aggregate of the taxes that would have been attributable to that income had it been included in the gross income of that beneficiary ratably for the year of distribution and the 5 preceding taxable years, or for the period that the trust accumulated or acquired income for that beneficiary, whichever period is shorter. Rev & T C §17745(d).

Income that is distributed to a beneficiary (whether vested or contingent) who is not a resident of California is taxable to that beneficiary only to the extent that the distributed income represents California-source income. The trustee must withhold tax on payments of income from California sources to nonresident beneficiaries that are not subject to payroll withholding. See Rev & T C §§18661-18677.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.60 C. Determining Source of Income

§11.60 C. Determining Source of Income

Interest, dividends, and other income from intangible personal property generally have a source at the taxpayer's state of residence. Gains and losses from the sale or exchange of real and tangible personal property have a source where the property is located. Rents and royalties also have a source where the property is located. See Instructions for FTB Form 541 (Specific Line Instructions-Income).

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§11.60A D. Double Taxation of Trust Income

In some cases, California-source income of a trust or income of a trust with a California-resident trustee or beneficiary subject to income taxation in California (see §11.58) also may be subject to income taxation in another state. This may occur because the trust is treated as a resident of another state under the law of that state. For example, the other state may tax the income of the trust solely on the basis of the residence of the trustee (*e.g.*, Arizona, Oregon) or the residence of the settlor or testator (*e.g.*, Illinois, Ohio) and some states may have a more expansive definition of resident trustee (*e.g.*, New York) or noncontingent beneficiary (*e.g.*, Connecticut).

Many states allow a resident trust a credit for taxes paid to another state on income that is also taxable in the resident state, but some states only allow a credit for taxes paid on a nonresident source income tax return (*e.g.*, Colorado, New York). For this reason, a trust that is deemed a resident of more than one state may face double or multiple taxation of trust income.

California allows a credit for income taxes paid to another state by a trust that is a resident of that state, even if the trust is also a resident of California. Rev & T C §§18002(a), 18003-18004. California also allows a trust a credit for taxes paid on source income of another state, unless the other state (*e.g.*, Arizona, Oregon) allows the trust a credit for taxes paid in California. Rev & T C §18001(a).

EXAMPLE: The income of a trust with two California-resident noncontingent beneficiaries and an individual trustee in Arizona derived from financial assets in a New York bank trust account may be taxable in all three states. A credit may be available in California (and Arizona) for taxes paid in New York, and a credit may be available in California for taxes paid in Arizona. However, the trust may be required to file a return in each state. The California income tax cannot be avoided as long as the beneficiaries reside in California, but the New York and Arizona income taxes probably could be avoided by transferring the trust administration and financial assets to a California bank.

When faced with double taxation of trust income, the trustee and beneficiaries should consider moving the trust situs by changing the location of the trustee or trust administration. Double taxation based on the trustee's residence often can be avoided by locating the trust administration in states that have no fiduciary income tax (*e.g.*, Nevada) or in states that require a combination of contacts to impose a tax on trust income (*e.g.*, Delaware). However, there may be no way to change the situs of a trust with real or tangible assets or income derived from a business operating in the taxing state.

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VI. REQUIREMENTS FOR FILING FIDUCIARY INCOME TAX RETURNS AND PAYMENT OF TAX

§11.61 A. Who Must File Return

IRS Form 1041 (U.S. Income Tax Return for Estates and Trusts), the federal fiduciary income tax return, and appropriate schedules, must be filed for every trust if there is:

- Any taxable income for the tax year (IRC §6012(a)(4));
- Gross income of $600 or more, regardless of the amount of taxable income (IRC §6012(a)(4)); or
- Any nonresident alien beneficiary (IRC §6012(a)(5)) (except as provided in IRC §§6013(g)-(h)).

FTB Form 541 (California Fiduciary Income Tax Return) must be filed for every trust (except certain grantor trusts; see §§11.76-11.81) if (Rev & T C §18505(e)-(f)):

- The net taxable income is over $100;
- The gross income exceeds $10,000, regardless of the net taxable income; or
- The trust has alternative minimum tax liability (see Instructions for FTB Form 541 (General Information—Who Must File).

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§11.62 B. Time for Filing Returns and Payment of Tax

Federal and state fiduciary income tax returns and tax payments are due on the 15th day of the fourth month following the close of the trust's tax year (April 15 of the next year for a calendar-year trust). IRC §6072(a); Treas Reg §1.6072-1(a); Rev & T C §18566. But see §§11.63-11.66 on extension of time to file and to pay taxes. With a few exceptions, most trusts must adopt a calendar year. See IRC §644.

California tax returns may be filed on paper, on magnetic media under Rev & T C §18409 (former Rev & T C §19524), or by electronic imaging under Rev & T C §18621.5. Rev & T C §18621. (Although former Rev & T C §19524 was renumbered as Rev & T C §18409 by Stats 2000, ch 863, §35, the reference to it in §18621 has not been amended accordingly as of this writing.)

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C. Extensions of Time for Filing Returns and Payment of Tax

§11.63 1. Federal Returns and Tax Payments

The IRS may grant an extension of time for filing the trust's income tax return (IRC §6081) and may grant an extension of time for payment of taxes (IRC §6161), except as to deficiencies resulting from negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax (IRC §6161(b)(3)). However, the IRS has shortened the period for an automatic extension of time to file a trust income tax return from the usual 6 months to 5 months, and prohibited additional extensions, to facilitate receipt by trust beneficiaries of their Schedule K-1s before they must file their individual returns. TD 9407, 2008-33 Int Rev Bull 330. See §11.64.

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§11.64 a. Extension for Filing Return

Any trust required to file an income tax return will be allowed an automatic 5-month extension of time to file if the trustee fulfills the following requirements (Temp Treas Reg §1.6081-6T(a)-(b), (g), applicable to extension applications filed on or after January 1, 2009, and before July 1, 2011):

- Submit IRS Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information and Other Returns) or an application in any other manner prescribed by the commissioner;
- File the application on or before the date prescribed for filing the return with the appropriate IRS office; and
- Show on the application the properly estimated tax amount for the taxable year.

An automatic extension of time for filing a trust income tax return does not extend the time for payment of any tax due on such return; neither does it extend the time for filing a beneficiary's income tax return or any tax due on the beneficiary's income tax return. Temp Treas Reg §1.6081-6T(c)-(d). Extensions beyond the automatic 5-month period are governed by Treas Reg §1.6081-1.

NOTE: The shorter 5-month period for trusts as compared with the 6-month period for individuals in Treas Reg §1.6081-4 is intended to allow beneficiaries to receive copies of Schedule K-1 reporting their share of distributable net income (DNI) from the trust before filing their own individual returns. See §11.47.

Note that the IRS commissioner can terminate an automatic extension at any time by mailing a notice of termination that gives at least 10 days' notice. Temp Treas Reg §1.6081-6T(e).

If the IRS Form 7004 has already been filed but additional time is needed, IRS Form 8800 (Application for Additional Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts) should be filed in duplicate. The application for an extension beyond the period of the automatic extension is for a "reasonable extension of time" up to 6 months after the original due date of the return. Treas Reg §1.6081-1(a). The IRS will respond by returning a copy of the application with an "approved" or "denied" stamp at the bottom. The granting of the request for additional time is at the discretion of the IRS, and it may be denied if an adequate case is not made for the delay in filing. Generally, however, the request is granted when there is some evidence that reasonable efforts were made to comply with the filing requirements.

The three basic purposes for seeking an extension of time to file are:

- To extend the time to make elections that must be filed with the return;
- Allow additional time to gather information that is essential to preparation of the return; and
- To avoid any penalties (see IRC §6651) that are imposed for a late filing without reasonable cause.

If an extension other than the automatic extension is granted, it is generally presumed that reasonable cause existed, and no penalties for late filing should be assessed.

WARNING: An extension of time to file is not an extension of time for payment of tax due. Treas Reg §1.6081-1(a). See §11.65. The trustee must make an estimate of the tax due when filing for an automatic extension. Temp Treas Reg §1.6081-6T(b)(3).

PRACTICE TIP: An additional copy of the extension application should be sent with the request that the Service acknowledge receipt and return it to the taxpayer. An addressed stamped envelope should be provided to the Service for this purpose.

An approved extension request should be attached to the return when it is filed.

If the IRS denies the extension request, it grants a 10-day grace period to file the return. On request, the IRS will often grant a longer grace period.

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§11.65 b. Extension for Payment of Tax

An extension of time for filing the fiduciary income tax return is not an extension of time for payment of the tax due. Treas Reg §1.6081-1(a). The trustee may request an extension of time to pay the trust's taxes by filing IRS Form 1127 (Application for Extension of Time for Payment of Tax). Granting such an extension of time for payment is discretionary (see IRC §6161), and ordinarily is allowed only in cases of undue hardship (described in Treas Reg §1.6161-1(b)), as alleged on the application. Treas Reg §1.6161-1. For example, the necessity to sell assets at market price to raise cash to pay taxes would not generally be considered an undue hardship. See Treas Reg §1.6161-1(b).

The application must be accompanied by a statement of assets and liabilities, an itemized statement of all receipts and disbursements for the 3 months preceding the due date of the amount to which the application relates, and evidence showing the undue hardship that would result from a refusal to grant the extension. Treas Reg §1.6161-1(c). In addition, if the application is approved, the district director usually requires a bond for the payment of the tax in an amount up to double the amount of the tax payment for which the extension is granted. See IRC §6165.

The application for an extension of time to pay should be prepared and signed by the trustee and must be filed with supporting documents on or before the date the tax is due. Treas Reg §1.6161-1(c). It must be filed with the district director where the trustee maintains legal residence or place of business (Treas Reg §1.6091-2(a)), regardless of whether the tax will be paid in that district. Treas Reg §1.6161-1(c). The extension is limited to 6 months. IRC §6161(a). Further extensions are allowed for payment of deficiencies. See IRC §6161(b).

Interest accrues on unpaid tax even if an extension to pay the tax is granted. Unlike interest that accrues during an extension of time to pay tax on a reversionary or remainder interest under IRC §6163 (see §12.28), interest that accrues under IRC §6601 during the period of an extension under IRC §6161 is not deductible. Interest on an extension under IRC §6163 is excluded from the definition of "personal interest" in IRC §163(h)(2)(E), but there is no comparable provision treating the interest on an extension under IRC §6161 as nonpersonal interest under IRC §163. See IRS Legal Memorandum 200836027 (noting that Temp Treas Reg §1.163-9T(b)(1)(v) still purports to allow such a deduction but is obsolete). A major purpose of obtaining the extension of time for payment of tax is to avoid penalties for late payment. However, even if an extension of time to pay is granted and no penalties are assessed, interest will be imposed on the delinquent tax as provided in IRC §§6621-6622. See §§11.67-11.70.

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§11.66 2. California Returns and Tax Payments

California grants an automatic 6-month extension of time (*e.g.*, until October 15 for returns due April 15) for filing trust income tax returns without the requirement of a written application. However, if the trustee estimates that there will be a tax balance due, payment of the balance should be made with FTB Form 3563 (Payment Voucher for Automatic Extension for Fiduciaries), on or before the original due date of the income tax return (April 15 in the case of calendar-year taxpayers). An extension of time for filing is not an extension of time for payment. The Franchise Tax Board may grant a reasonable extension for payment of tax for good cause. Rev & T C §18567(c).

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D. Penalties and Interest

§11.67 1. Penalty for Late Filing

A 5-percent late-filing penalty is applied to the net tax due for each month (or fraction thereof) that the return is late, up to a maximum of 25 percent. If the return is not filed within 60 days of its due date (determined with regard to any extensions of time to file) the minimum penalty is the lesser of $135 or 100 percent of the tax due. IRC §6651(a). These penalties apply only in the absence of reasonable cause for the late filing or if the failure to file is due to willful neglect. If the failure to file the return is fraudulent, higher penalties apply. IRC §6651(f). California imposes the same penalties. See Rev & T C §19131.

To avoid imposition of a penalty, an approved extension request should be attached to the return when it is filed. If the requested extension was denied, penalties for late filing may still be avoided if the Internal Revenue Service agrees to waive them. If the request for extension was filed late, the IRS will not usually grant the request. Waiver of late filing penalties is discretionary. Treas Reg §301.6651-1(c). With the filed return, the trustee should provide a detailed statement explaining the reasons for the delay.

For purposes of IRC §6651, a month is defined as the period that terminates with the numerically corresponding date in the succeeding calendar month, and if none, with the last day of the succeeding month. For example, if the applicant, required to file on April 15, obtains a 6-month extension, the return would be due on October 15; but a return due 6 months from August 30 would be due on the last day of February. Treas Reg §301.6651-1(b)(2).

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§11.68 2. Penalty for Failure to Pay Tax When Due

A late-payment penalty may be imposed if less than the amount shown on the return as due is paid on time. The federal penalty is one-half of 1 percent (0.005) of the net tax due for each month (or fraction of a month) the tax remains unpaid. This is calculated from the date the tax is due; the maximum penalty is 25 percent. IRC §6651(a)(2).

That penalty is doubled to 1 percent (0.01) if payment is not made within 10 days after notice is given by the IRS under IRC §6331(d), or immediately if notice is given under IRC §6331(a). IRC §6651(d). Section 6331 concerns levy on property.

The failure-to-pay penalty is limited to half the usual rate (0.0025 percent rather than 0.005 percent) for any month in which an installment payment agreement with the IRS is in effect. IRC §6651(h).

The California late-payment penalty is 5 percent of the total unpaid tax plus one-half of 1 percent (0.005) of the remaining tax for each month the tax remains unpaid, to a maximum of 40 months. Rev & T C §19132(a)(2). The total penalty may not exceed 25 percent of the total unpaid tax. Rev & T C §19132(a)(3). These penalties are in addition to any interest due on the late payment (for the interest assessed, see §11.69).

If both the late-filing and late-payment penalties apply, the penalty for failure to file is reduced dollar for dollar by the penalty for failure to pay (but not below zero ($0)). Thus, if the penalty for failure to pay is less than or equal to the penalty for failure to file, the penalty for failure to pay is, in effect, ignored. A penalty for failure to pay will be assessed only to the extent that it exceeds the penalty for failure to file. IRC §6651(c); Rev & T C §19132(b).

The highest penalty applicable is 25 percent of the net tax due if the return is not filed within 5 months of its due date and no reasonable cause has been shown. IRC §6651(c)(1); Rev & T C §19132. However, if the penalty for failure to file within 60 days of the return's due date applies, that penalty cannot be reduced below the lesser of $100 or 100 percent of the net tax due. IRC §§6651(c), 6651(a). As with the penalty for late filing, the penalty for late payment can be avoided if reasonable cause for the delay can be shown.

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§11.69 3. Interest on Late Payment of Tax

Even if an extension of time for payment of tax has been granted, interest will be charged on the net taxes due from the due date for payment until the tax is paid. IRC §6601. The interest is charged against the net tax due at a floating rate computed at 3 percent over the federal "short-term rate." IRC §6621(a)(2), (b). The federal short term rate is compounded daily (IRC §6622), determined on a monthly basis under IRC §1274(d), and is rounded up to the next full percentage point (IRC §6621(b)(3)). For interest on late payment of California tax, see Rev & T C §§19101, 19521.

The interest due is in addition to any tax or penalties due, and is imposed only on the net tax due (IRC §6651(b)). It is not imposed on any penalties or additional amounts assessed unless those penalties or additional amounts are not paid within 21 calendar days from the date of the notice and demand by the IRS, or 10 business days if the amount is equal to or exceeds $100,000. IRC §6601(e)(2)(A). If interest is paid within 21 calendar days (or 10 business days if the amount equals or exceeds $100,000) after a notice and demand by the IRS, no interest is owing for those few days between the date of the notice and the date of payment. IRC §6601(e)(3).

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§11.70 4. Other Penalties

In addition to the penalties for failure to file and failure to pay tax, additional civil and criminal penalties may be imposed for negligence, fraud, valuation overstatement, substantial underpayment of tax, understatement of liability, or attempts to evade or defeat a tax. See, *e.g.*, IRC §§6672, 7201-7203. California imposes a $50 penalty on the trustee for each beneficiary to whom the trustee fails to provide Schedule K-1. See Instructions for FTB Form 541 (General Information—Interest and Penalties).

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E. Required Fiduciary Tax Forms

1. Federal Tax Return and Schedules

§11.71 a. United States Fiduciary Income Tax Return: Form 1041

On IRS Form 1041, the trustee provides a summary of income, deductions, credits, and the trust tax computation. The form includes Schedule A, for charitable deduction computations, and Schedule B, for computation of income distribution deductions. Both simple and complex trusts are now required to complete Schedules A and B. A copy of the governing instrument need not be attached to the return unless the IRS requests it. Treas Reg §1.6012-3(a)(2).

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§11.72 b. Supplemental Schedules to Form 1041

Schedule D (IRS Form 1041—Capital gains and losses). This schedule must be filed with IRS Form 1041 if the trust realizes any gains or losses on the sale or exchange of capital assets. The net gain or loss is part of the computation of the trust's gross income.

Schedule I (IRS Form 1041—Alternative minimum tax). This schedule is used to compute the trust's alternative minimum taxable income, the distribution deduction on a minimum-tax basis, and the trust's alternative minimum tax. See §11.35.

Schedule J (IRS Form 1041—Trust allocation of an accumulation distribution for certain complex trusts). This form is used for a complex domestic trust that has specified excess distributions, as defined in IRC §665. The form is used when the "throwback rules" apply (*i.e.*, to distributions from qualified trusts made in tax years prior to a tax year beginning after August 5, 1997). Under limited circumstances, the throwback rule can also apply to distributions made in tax years beginning after August 5, 1997.

Schedule K-1 (IRS Form 1041—Beneficiary's share of, e.g., income, deductions, credits). This schedule is filed with IRS Form 1041 for each beneficiary who received or is deemed to have received income during the trust's tax year. Schedule K-1 is useful to both the beneficiary and the Internal Revenue Service. It discloses the beneficiary's share of trust income, deductions, tax-preference items, and credits during the trust's tax year that are to be reported on the beneficiary's personal income tax return.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.72A c. Additional Schedules and Forms

§11.72A c. Additional Schedules and Forms

Schedule C of IRS Form 1040 and Schedule E of IRS Form 1040 may be used to report income from a trade or business and income from rents or royalties, respectively. Depreciation and amortization may be reported on IRS Form 4562. If used, these forms should be attached to and filed with IRS Form 1041.

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§11.73 2. California Fiduciary Income Tax Return: FTB Form 541

California FTB Form 541 is similar to federal IRS Form 1041. It is used for each trust required to file a California fiduciary income tax return and it includes a summary of income, deductions, credits, and the tax computation for the trust. It also includes a section for voluntary contributions to specific funds and programs. Form 541, like the federal form, includes the charitable deduction and income-distribution-deduction computation schedules—Schedules A and B, respectively. Charitable trusts may be required to file additional California forms, such as FTB Form 109, Form 199, Form 541-A, or Form 541-B. A copy of the trust instrument need not be filed unless requested by the Franchise Tax Board. See Instructions for FTB Form 541 (General Information—Decedent's Will and Trust Instrument).

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§11.74 F. Estimated Tax Payments

Federal estimated tax payments are required if the current year's tax liability, reduced by any credits, will be at least $1000. See IRC §6654(a), (e)(1). To avoid the penalty for underpayment of estimated tax, the payments must equal the lesser of 90 percent of the current year's tax or 100 percent of the prior year's tax (110 percent if the prior year's adjusted gross income was more than $150,000, and less than two-thirds of either year's income is from farming or fishing). IRC §6654(d)(1), (i). For tax years beginning in 2009, qualified individuals may substitute 90 percent of the prior year's tax for 100 (or 110) percent. IRC §6654(d)(1)(D). "Qualified individual" means an individual whose adjusted gross income was less than $500,000 in the preceding tax year and whose certification shows that more than 50 percent of the gross income was from a small business (fewer than 500 employees). For trusts, adjusted gross income is determined under IRC §67(e). IRC §6654(d)(1)(D)(v), (*l*)(1). Like an individual, a trust may compute its estimated tax payments using the annualized income installment method.

For 2 years following the decedent's death, if the trust receives the residue of the decedent's estate under the decedent's will, estimated tax payments are not required from a trust that was treated in its entirety as a grantor trust of a decedent. IRC §6654(*l*)(2).

California law generally conforms to federal law, except that no payments are required if the current or prior year's tax liability is less than $500. Rev & T C §19136.

If a trust makes estimated tax payments, the trustee may elect to treat all or any portion of a payment as made by the beneficiaries. IRC §643(g); Rev & T C §17731. The election is made on federal IRS Form 1041-T and California FTB Form 541-T and must be made within 65 days after the end of the trust's taxable year. IRC §643(g)(2). The amount allocated to the beneficiaries is treated as an amount properly paid or credited to them on the last day of the trust's taxable year. The amount is treated as a payment by the beneficiaries for the fourth quarter, regardless of the date on which the trust made the payment. IRC §643(g)(1).

Federal estimated tax payments should be made with IRS Form 1041-ES. California estimated tax payments should be made with FTB Form 541-ES.

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§11.75 G. Special Filing Requirements for Grantor Trusts

The requirements for filing fiduciary income tax returns for grantor trusts vary depending on whether the grantor receives all or a portion (see §§11.76-11.77) of the income from the trust and, if all the trust income is received by the grantor, whether the trust is owned by one or more grantors or other persons (see §§11.78-11.81). Note that a husband and wife are considered one grantor for this purpose.

Because California generally follows the federal rules regarding grantor trusts (see Rev & T C §17731), the following discussion also applies to California filing requirements. References to the corresponding California tax form are shown in parentheses immediately after the reference to a federal tax form.

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§11.76 1. Portion of Trust Income Taxed to Grantor

To the extent any person, including the grantor and his or her spouse, is treated as the owner of the trust under the grantor trust rules, any item of trust income (and any related deductions and credits allocable to it) that is attributable to that person is taxable to him or her and is reportable on his or her individual income tax return (see §§11.78-11.81). IRC §671. See IRS Form 1040 (and FTB Form 540). If reported on the individual income tax return, these items are not reported by the trustee on IRS Form 1041 (or FTB Form 541). However, the trustee must attach a separate statement to Form 1041 (and Form 541) listing those items as well as the taxpayer identification number (TIN) of the owners to whom such items are taxable. Treas Reg §1.671-4(a). For a sample statement form, see §11.77.

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Source: Estate Planning/California Trust Administration/11 Income Taxation of Trusts/§11.77 2. Form: Portion of Trust Income Taxed to Grantor

§11.77 2. Form: Portion of Trust Income Taxed to Grantor

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This trust is a grantor trust in part within the meaning of Internal Revenue Code §671, and all of the following items of income and expense of the trust for this taxable year are reportable directly on the individual tax return of the grantor, _ _[*name of grantor*]_ _, whose social security number is _ _ _ _ _ _.

Comment: All items of income and expense should be listed separately.

If all of the trust is owned by one grantor, and the trustee chooses to use the reporting method under Treas Reg §1.671-4(a), replace "in part" with "in whole" in the first line. See discussion in §11.76.

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3. All Trust Income Taxed to Grantor

§11.78 a. Trust Is Owned by One Grantor or One Other Person

If one person, such as the grantor, is considered the owner of the trust, then the trust income (and any trust deductions or credits attributable to that portion) is taxed to that person rather than to the trust. IRC §671; Treas Reg §1.671-4(b)(2). See §11.57. If a husband and wife own all of a trust and file a joint return, the trust is considered to be owned by one grantor. Treas Reg §1.671-4(b)(8).

The trustee can proceed either under Treas Reg §1.671-4(a) (see §11.76) or under Treas Reg §1.671-4(b)(2)(i), which provides two alternatives: The trustee may furnish payors to the trust with either (1) the name and TIN of the grantor and the address of the trust or (2) the name, TIN, and address of the trust.

NOTE: The second alternative is essentially for the use of institutional trustees because it requires the trustee to then file an IRS Form 1099 showing the trust as the payor and the grantor as the payee. See Drafting California Irrevocable Trusts §3.39A (3d ed Cal CEB 1997).

Under the first alternative, the trustee is not required to file any return with the IRS. Treas Reg §1.671-4(b)(2)(ii)(B).

California also accepts the optional filing requirements stated in Treas Reg §1.671-4(b)(2). See Instructions to FTB Form 541.

Under either alternative, unless the grantor or other person is the trustee or cotrustee, the trustee must furnish the grantor with a statement that (Treas Reg §1.671-4(b)(2)(ii)-(iii)):

- Shows all items of income, deduction, and credit of the trust for the taxable year;
- Identifies the payor of each item;
- Provides the grantor or other person with sufficient information to take the items into account in computing the grantor's or other person's taxable income; and
- Informs the grantor that the items of income, deduction, and credit, and other information on the statement must be included in computing taxable income and credits on the grantor's income tax return.

The trustee must retain such statements for 3 years from the date of the particular return. Treas Reg §1.671-4(d).

On trusts owned by two or more grantors, see §11.79. On trusts that cease to be owned by the grantor, see §11.80. On changing trust reporting methods, see §11.81.

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§11.79 b. Trust Is Owned by Two or More Grantors or Other Persons

If all of the trust is treated as owned by two or more grantors or other persons, the trustee must furnish to all payors the name, taxpayer identification number, and address of the trust. Treas Reg §1.671-4(b)(3). The trustee must also file IRS Form 1099 and an information statement as described in §11.78. Both forms must show which items of income (for Form 1099) and deductions and credits (for information statement) are attributable to each portion of the trust treated as owned by each grantor or other person. Treas Reg §1.671-4(b)(3)(ii)(A)-(B). On trusts owned by one grantor, see §11.78.

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§11.80 c. Grantor Ceases to Be Owner

If the grantor is no longer considered the owner of the trust or a portion of the trust (see §11.76), the trust fiduciary must obtain a taxpayer identification number for the trust and file IRS Form 1041 (and FTB Form 541) for the income not "owned" by the grantor. See Treas Reg §301.6109-1(a). For those trusts, the fiduciary should follow the general filing requirements for a trust's income tax return that are outlined in §§11.61-11.66.

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§11.81 d. Changing Trust Reporting Methods

It the trustee of a grantor trust has filed a Form 1041 for any taxable year after 1995, the trustee must file a final Form 1041 before using the reporting method described in Treas Reg §1.671-4(b) (see §11.78). Treas Reg §1.671-4(g). The final Form 1041 must state on the front: "Pursuant to §1.671-4(g), this is the final Form 1041 for this grantor trust."

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§11.82 H. Refund Procedure

If the trustee makes a determination that the trust has overpaid its tax, a refund claim must be filed. Usually, this is done by filing an amended return (IRS Form 1041X (amended)). The trust income tax return may offset the federal estate tax return (IRS Form 706) because income tax liabilities may be deducted under IRC §2053(a)(3) on the estate tax return. However, in *Estate of McMorris v Commissioner* (10th Cir 2001) 243 F3d 1254, the court held that postdeath facts may not be considered in determining a debt for estate tax purposes, even though the same post-death facts resulted in a $3 million dollar refund of income tax, a very beneficial result for the taxpayer in this case. See also *Estate of Smith v U.S.* (5th Cir 1999) 198 F3d 515 (estate tax deduction for claim against estate and value of income tax benefit for restoring income previously received must be based on information known at date of death, not based on eventual settlement amount). Proposed regulations would provide that postdeath adjustments increasing a tax liability of the decedent will increase the amount of the deduction taken under IRC §2053(a)(3), but that any refund determined to be due to and received by the estate reduces the amount of the deduction for that tax liability under IRC §2053(a)(3). Prop Treas Reg §20.2053-6(g). See §12.41.

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12

Estate Tax Returns

Sandra Price

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I. ADVISING TRUSTEE AND PREPARING RETURNS

§12.1 A. Understanding Estate Tax System

With a fully funded revocable trust, at the settlor's death the obligation of preparing and filing the estate tax return and paying the estate tax falls on the trustee of the revocable trust. Accordingly, practitioners handling trust administration matters in the post-death context need to have a basic understanding of the federal and California estate tax system in order to properly advise such trustees. In larger estates, an understanding of the generation-skipping transfer (GST) tax system is also necessary at the death of a settlor and, possibly, at the death of a beneficiary.

WARNING: The preparer of the estate tax return and other persons who merely supply information used in the preparation of the return—including attorneys who give advice—may be subject to individual penalties for understatement of tax liability under IRC §6694. The penalties may apply whenever there is an understatement of tax as a result of unreasonable positions taken on the return unless there is substantial authority for each position, or there is a reasonable basis for each position and the position is disclosed on the return. See discussion of preparer penalties in §11.3A.

This chapter is designed to provide practitioners with both an understanding of the estate and GST tax systems as well as information about the preparation and filing of estate tax returns and payment of estate taxes. Tax considerations relevant to trusts are also covered in Drafting California Revocable Trusts, chap 4 (4th ed Cal CEB 2003) and Drafting California Irrevocable Trusts, chap 2 (3d ed Cal CEB 1997). Handling Postmortem Trust Administration: A Checklist, steps 31-34 (Cal CEB Action Guide September 2009) outlines, on a step-by-step basis, pertinent estate and GST tax issues.

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§12.2 B. Federal Estate Tax

The federal estate tax is an excise tax imposed on the transfer of property from a decedent and is based on the sum of (1) the decedent's taxable estate, that is, the gross estate less allowable deductions and the state death tax deduction (line 3c of Part 2 of the September 2009 revision of Form 706) and (2) the "adjusted taxable gifts" made by the decedent after December 31, 1976 (line 4 of Part 2 of Form 706), which are not included in the decedent's gross estate under IRC §§2035-2038, §2040, or §2042. The amount of tax is reduced by allowable credits. See generally IRC §§2001-2058.

A federal estate tax return must be filed if the sum of (1) the decedent's gross estate and (2) the "adjusted taxable gifts" made by the decedent after December 31, 1976, exceeds the applicable exclusion amount under IRC §2010(c) available in the calendar year of the decedent's death. IRC §6018. See §12.9.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38) the estate tax and generation-skipping transfer (GST) tax will be repealed in 2010. However, this repeal will expire or "sunset" on January 1, 2011, unless Congress and the President approve proposed legislation that will make the estate and GST taxes permanent, with various changes to the applicable exclusion amount, tax rate, and perhaps the valuation of minority interests in certain types of family-owned entities, depending on the final version of the legislation ultimately enacted. EGTRRA-2001 §901. In the absence of any such legislation, the estate tax and GST tax will not apply to decedents dying in 2010 and, if changes to the estate tax and GST tax that incorporate one or more of the provisions contained in proposed legislation are not enacted on or before December 31, 2010, the old tax system (including, among other provisions, the $1 million estate tax applicable exclusion amount (AEA) previously scheduled for 2006, the $1 million (indexed for inflation) GST exemption, and the 55-percent top tax rate) will return in 2011.

During 2009, the amount that an individual can transfer exempt from estate tax and GST tax is $3.5 million, and the rate applied to taxable transfers at death is 45 percent. Under EGTRRA-2001, even after the estate tax is repealed, a gift tax will still be imposed on transfers of assets during the transferor's lifetime. The gift tax applicable exclusion amount (AEA) is $1 million and will be frozen at that level with no subsequent increase.

The myriad planning opportunities and pitfalls presented by EGTRRA-2001 are beyond the scope of this title, and this chapter continues to focus on the trustee's obligation to prepare and file estate tax returns. For more detailed information about the impact of EGTRRA-2001 from a planning perspective, see Drafting California Irrevocable Trusts (3d ed Cal CEB 1997) and Drafting California Revocable Trusts (4th ed Cal CEB 2003).

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§12.3 C. California Estate Tax

California does not have an inheritance tax, but it did impose a "pick-up" tax on estates of decedents dying before 2005 equal to that portion of the maximum amount of the state death tax credit allowable in determining the federal estate tax liability attributable to estate property located in California. For decedents dying in 2005-2010, there is no California estate tax. The "pick-up" tax, under current law, will be reinstated for decedents dying in 2011 and thereafter.

To claim the state death tax credit, however, the estate actually must have paid the "pick-up" tax to the state. Rev & T C §13302. Under EGTRRA-2001, the credit for state estate taxes is repealed for decedents dying in 2005 and replaced with a deduction for state death taxes paid as determined under IRC §2058. Because the California estate tax is tied to the amount of the IRC §2011 state death tax credit, the tax does not apply to estates of decedents dying after 2004 and before 2011. See §12.55B.

Assuming that any new legislation that modifies or extends the changes enacted under EGTRRA-2001 does not restore the state death tax credit under IRC §2011, California may try to enact some form of estate or inheritance tax in the next several years. The practitioner should regularly review California law related to estate, inheritance, or other types of state death taxes. See §12.64.

NOTE: Although the California inheritance tax has been repealed, it still applies to estates of decedents dying before (and gifts made before) June 8, 1982. Rev & T C §13301.

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§12.4 D. Generation-Skipping Transfer (GST) Tax

Practitioners must also be concerned with the federal generation-skipping transfer (GST) tax (IRC §§2601-2664), which is imposed on certain transfers to "skip persons" each time an interest or power of a successive generation of trust beneficiaries terminates. As described in §12.2, the GST tax will be repealed in 2010 and reinstated in 2011 unless further legislation is enacted. California imposes on every generation-skipping transfer a "pick-up" tax that equals the amount allowable as a credit for state GST taxes under IRC §2604. Rev & T C §16710(a). (Under EGTRRA-2001, this credit was eliminated for transfers after December 31, 2004. IRC §2604(c).) A detailed discussion of the GST tax is beyond the scope of this text, although it is summarized in §§12.70-12.78. See also California Will Drafting, chap 15 (3d ed Cal CEB 1992), Drafting California Revocable Trusts, chap 4 (4th ed Cal CEB 2003), and California Estate Planning, chap 11 (Cal CEB 2002).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.5 E. Initial Meeting With Trustee

§12.5 E. Initial Meeting With Trustee

In many cases, the trustee of a revocable trust that becomes irrevocable at the settlor's death is a family member or friend who is not familiar with estate tax issues. Frequently, the family or trustee may think that there is no estate tax on the trust assets, confusing "avoiding probate" with "avoiding estate taxes." At the initial meeting, it is important to both

- Introduce the basic concept of the estate tax system (*i.e.,* a "snapshot" of the value of the decedent's assets, valued at the date of death, less specified deductions—where the includable assets may go well beyond traditional concepts of ownership); and
- Emphasize that the trustee's principal duties include the timely filing of the estate tax return 9 months from the date of death and the payment of estate taxes, and that it is never too soon to focus on these issues.

PRACTICE TIP: Although 9 months may sound like a far-off date, the trustee should be warned that it can be time-consuming to collect the information and appraisals necessary to prepare a complete estate tax return. Similarly, if liquidity is an issue, formulating strategies for payment of the estate tax and the actual sales may require time.

The initial meeting is also an appropriate time to discuss who will be preparing the estate tax return. A long-time accountant who is knowledgeable about the deceased settlor's assets and affairs may be able to prepare the estate tax return very efficiently; and, if the accountant will be preparing the fiduciary income tax returns for the trust during its "administrative" phase and for any continuing trusts, it is often most efficient if the estate and income tax returns are prepared by the same person. Even with this advantage, however, consider whether the accountant has prepared estate tax returns before. Estate tax experience can be crucial. If the accountant prepares the return, the attorney should review it generally and, in particular, make sure that it properly reflects appropriate elections, including protective elections for special use valuation (IRC §2032A) or the installment payment of estate tax (IRC §6166), discount valuation planning, determination of amounts passing under formula bequests, and the terms of the deceased settlor's trust.

PRACTICE TIP: Regardless of who prepares the estate tax return, make sure there is a letter documenting this responsibility. A letter should be sent to the accountant confirming the responsibilities for all tax-related matters, stating who will prepare the estate and income tax returns and any extension requests, who will apply for the trust's taxpayer identification number, who will advise about retirement account distributions, who will be responsible for deciding whether the revocable trust should make an election under IRC §645 to be treated as part of the deceased settlor's estate for income tax purposes and, if so, who will be responsible for ensuring that the election is timely made, and so on. For a sample letter (applicable to an unmarried grantor and trust beneficiaries who are not family members) confirming that the accountant will handle all tax matters, see §13.106. For IRC §645 election, see §§11.53-11.53C.

Another area of inquiry at the initial meeting is the analysis of who owns the deceased settlor's assets, *e.g.,* whether they are held in the name of the trust, held outside the trust in decedent's sole name, in the names of the decedent and spouse as community property or community property with right of survivorship or as joint tenants with right of survivorship, or in the names of the decedent and some other person, as tenants in common or in joint tenancy. It is important to determine whether the assets pass by terms of a contract, *e.g.,* by beneficiary designation on life insurance policies, commercial annuity contracts, or retirement benefits. These differences are important in terms of the information that must be included on the estate tax return, including the value that must be reported for the asset, and the determination of who will actually file the return. See §12.10.

Some practitioners ask the trustee to bring all asset information to the initial meeting. Others use the initial meeting as an opportunity to provide the client with an overview of the post-death process and to provide an asset/liability checklist. Both the attorney and the trustee should understand that the gathering of information for preparation of the estate tax return is an ongoing, evolving process.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.6 F. Using Checklists

§12.6 F. Using Checklists

Two checklists are included in §§12.79-12.80. Once the reader understands the estate tax filing procedures and estate tax laws, these may be used to ensure that matters are not overlooked and to provide a framework for making certain decisions. The estate tax return form itself (IRS Form 706) serves as its own checklist in many respects. Going through each schedule and each schedule's instructions is a good way of making sure that all necessary information is obtained and reported. See also Handling Postmortem Trust Administration: A Checklist, steps 31-34 (Cal CEB Action Guide September 2009).

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II. FEDERAL ESTATE TAX PROCEDURE

§12.7 A. Tax Forms to Be Filed Immediately

A taxpayer identification number (TIN), which is obtained by filing IRS Form SS-4, is not required when filing a federal estate tax return. The return is filed under the decedent's social security number. A TIN must still be obtained, however, by the personal representative of the decedent's estate in connection with the income tax returns that must be filed by the decedent's estate. A separate TIN must be obtained by the trustee of any revocable grantor trust created by the decedent, to the extent it was permitted to use the decedent's social security number as its taxpayer identification number during the decedent's lifetime under Treas Reg §1.671-4. See §11.10. Even a revocable trust that is a qualified revocable trust, as defined in Treas Reg §1.645-1(b)(1), and that elects to be treated as part of the decedent's estate under IRC §645, must obtain a separate TIN. See Treas Reg §§1.645-1(d)(1), 301.6109-1(a)(3). See also §§11.53-11.53C for discussion of IRC §645 election.

The representative must give written notice of the fiduciary relationship to the IRS. IRS Form 56 (Notice Concerning Fiduciary Relationship) is used for this purpose and should be completed and filed with the IRS. Form 56 should also be sent to the Franchise Tax Board. See §11.8.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/ B. Federal Estate Tax Return/§12.8 1. Official Form: United States Estate (and Generation-Skipping Transfer) Tax Return (IRS Form 706)

B. Federal Estate Tax Return

§12.8 1. Official Form: United States Estate (and Generation-Skipping Transfer) Tax Return (IRS Form 706)



Form **706**
(Rev. September 2009)

Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

Estate of a citizen or resident of the United States (see separate instructions).
To be filed for decedents dying after December 31, 2008, and before January 1, 2010.

OMB No. 1545-0015

Part 1—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any)	1b Decedent's last name		2 Decedent's Social Security No.
3a County, state, and ZIP code, or foreign country, of legal residence (domicile) at time of death	3b Year domicile established	4 Date of birth	5 Date of death
	6b Executor's address (number and street including apartment or suite no.; city, town, or post office; state; and ZIP code) and phone no.		
6a Name of executor (see page 5 of the instructions)			
6c Executor's social security number (see page 5 of the instructions)			Phone no. ( )
7a Name and location of court where will was probated or estate administered			7b Case number

8 If decedent died testate, check here ▶ ☐ and attach a certified copy of the will. 9 If you extended the time to file this Form 706, check here ▶ ☐

10 If Schedule R-1 is attached, check here ▶ ☐

Part 2—Tax Computation

1	Total gross estate less exclusion (from Part 5—Recapitulation, page 3, item 12)	1	
2	Tentative total allowable deductions (from Part 5—Recapitulation, page 3, item 22)	2	
3a	Tentative taxable estate (before state death tax deduction) (subtract line 2 from line 1)	3a	
b	State death tax deduction	3b	
c	Taxable estate (subtract line 3b from line 3a)	3c	
4	Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))	4	
5	Add lines 3c and 4	5	
6	Tentative tax on the amount on line 5 from Table A on page 4 of the instructions	6	
7	Total gift tax paid or payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)	7	
8	Gross estate tax (subtract line 7 from line 6)	8	
9	Maximum unified credit (applicable credit amount) against estate tax . 9		
10	Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed $6,000. See page 6 of the instructions.) 10		
11	Allowable unified credit (applicable credit amount) (subtract line 10 from line 9)	11	
12	Subtract line 11 from line 8 (but do not enter less than zero)	12	
13	Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.) 13		
14	Credit for tax on prior transfers (from Schedule Q) 14		
15	Total credits (add lines 13 and 14)	15	
16	Net estate tax (subtract line 15 from line 12)	16	
17	Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)	17	
18	Total transfer taxes (add lines 16 and 17)	18	
19	Prior payments. Explain in an attached statement	19	
20	Balance due (or overpayment) (subtract line 19 from line 18)	20	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Sign Here

▶ Signature of executor ▶ Date

▶ Signature of executor ▶ Date

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ▶ ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN ▶	
		Phone no. ( )	

Print

Form 706 (Rev. 9-2009)

Estate of: | **Decedent's Social Security Number**

Part 3—Elections by the Executor

Please check the "Yes" or "No" box for each question (see instructions beginning on page 7). | **Yes** | **No**

Note. Some of these elections may require the posting of bonds or liens.

1	Do you elect alternate valuation?	**1**		
2	Do you elect special-use valuation? If "Yes," you must complete and attach Schedule A-1.	**2**		
3	Do you elect to pay the taxes in installments as described in section 6166? If "Yes," you must attach the additional information described on pages 10 through 12 of the instructions. **Note. By electing section 6166, you may be required to provide security for estate tax deferred under section 6166 and interest in the form of a surety bond or a section 6324A lien.**	**3**		
4	Do you elect to postpone the part of the taxes attributable to a reversionary or remainder interest as described in section 6163?	**4**		

Part 4—General Information

(Note. Please attach the necessary supplemental documents. **You must attach the death certificate.)** (see instructions on page 12)

Authorization to receive confidential tax information under Regs. sec. 601.504(b)(2)(i); to act as the estate's representative before the IRS; and to make written or oral presentations on behalf of the estate if return prepared by an attorney, accountant, or enrolled agent for the executor:

Name of representative (print or type)	State	Address (number, street, and room or suite no., city, state, and ZIP code)

I declare that I am the ☐ attorney/ ☐ certified public accountant/ ☐ enrolled agent (you must check the applicable box) for the executor and prepared this return for the executor. I am not under suspension or disbarment from practice before the Internal Revenue Service and am qualified to practice in the state shown above.

Signature	CAF number	Date	Telephone number

1 Death certificate number and issuing authority (attach a copy of the death certificate to this return).

2 Decedent's business or occupation. If retired, check here ▶ ☐ and state decedent's former business or occupation.

3 Marital status of the decedent at time of death:

- ☐ Married
- ☐ Widow or widower—Name, SSN, and date of death of deceased spouse ▶
- ☐ Single
- ☐ Legally separated
- ☐ Divorced—Date divorce decree became final ▶

4a Surviving spouse's name	**4b** Social security number	**4c** Amount received (see page 12 of the instructions)

5 Individuals (other than the surviving spouse), trusts, or other estates who receive benefits from the estate (do not include charitable beneficiaries shown in Schedule O) (see instructions).

Name of individual, trust, or estate receiving $5,000 or more	Identifying number	Relationship to decedent	Amount (see instructions)
All unascertainable beneficiaries and those who receive less than $5,000 ▶			
Total			

Please check the "Yes" or "No" box for each question.		**Yes**	**No**
6	Does the gross estate contain any section 2044 property (qualified terminable interest property (QTIP) from a prior gift or estate) (see page 12 of the instructions)?		
7a	Have federal gift tax returns ever been filed? If "Yes," please attach copies of the returns, if available, and furnish the following information:		
7b	Period(s) covered / **7c** Internal Revenue office(s) where filed		
8a	Was there any insurance on the decedent's life that is not included on the return as part of the gross estate?		
b	Did the decedent own any insurance on the life of another that is not included in the gross estate?		

(continued on next page)

Part 4—General Information *(continued)*

If you answer "Yes" to any of questions 9–16, you must attach additional information as described in the instructions.		Yes	No
9	Did the decedent at the time of death own any property as a joint tenant with right of survivorship in which **(a)** one or more of the other joint tenants was someone other than the decedent's spouse, and **(b)** less than the full value of the property is included on the return as part of the gross estate? If "Yes," you must complete and attach Schedule E		
10a	Did the decedent, at the time of death, own any interest in a partnership (for example, a family limited partnership), an unincorporated business, or a limited liability company; or own any stock in an inactive or closely held corporation?		
b	If "Yes," was the value of **any** interest owned (from above) discounted on this estate tax return? If "Yes," see the instructions for Schedule F on page 20 for reporting the total accumulated or effective discounts taken on Schedule F or G		
11	Did the decedent make any transfer described in section 2035, 2036, 2037, or 2038 (see the instructions for Schedule G beginning on page 15 of the separate instructions)? If "Yes," you must complete and attach Schedule G		
12a	Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime?		
b	Were there in existence at the time of the decedent's death any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship?		
c	Was the decedent receiving income from a trust created after October 22, 1986, by a parent or grandparent? If "Yes," was there a GST taxable termination (under section 2612) upon the death of the decedent?		
d	If there was a GST taxable termination (under section 2612), attach a statement to explain. Provide a copy of the trust or will creating the trust, and give the name, address, and phone number of the current trustee(s).		
e	Did the decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b? If "Yes," provide the EIN number to this transferred/sold item. ►		
13	Did the decedent ever possess, exercise, or release any general power of appointment? If "Yes," you must complete and attach Schedule H		
14	Did the decedent have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?		
15	Was the decedent, immediately before death, receiving an annuity described in the "General" paragraph of the instructions for Schedule I or a private annuity? If "Yes," you must complete and attach Schedule I		
16	Was the decedent ever the beneficiary of a trust for which a deduction was claimed by the estate of a pre-deceased spouse under section 2056(b)(7) and which is not reported on this return? If "Yes," attach an explanation		

Part 5—Recapitulation

Item number	Gross estate		Alternate value	Value at date of death
1	Schedule A—Real Estate	1		
2	Schedule B—Stocks and Bonds	2		
3	Schedule C—Mortgages, Notes, and Cash	3		
4	Schedule D—Insurance on the Decedent's Life (attach Form(s) 712)	4		
5	Schedule E—Jointly Owned Property (attach Form(s) 712 for life insurance)	5		
6	Schedule F—Other Miscellaneous Property (attach Form(s) 712 for life insurance)	6		
7	Schedule G—Transfers During Decedent's Life (att. Form(s) 712 for life insurance)	7		
8	Schedule H—Powers of Appointment	8		
9	Schedule I—Annuities	9		
10	Total gross estate (add items 1 through 9)	10		
11	Schedule U—Qualified Conservation Easement Exclusion	11		
12	Total gross estate less exclusion (subtract item 11 from item 10). Enter here and on line 1 of Part 2—Tax Computation	12		

Item number	Deductions		Amount
13	Schedule J—Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims	13	
14	Schedule K—Debts of the Decedent	14	
15	Schedule K—Mortgages and Liens	15	
16	Total of items 13 through 15	16	
17	Allowable amount of deductions from item 16 (see the instructions for item 17 of the Recapitulation)	17	
18	Schedule L—Net Losses During Administration	18	
19	Schedule L—Expenses Incurred in Administering Property Not Subject to Claims	19	
20	Schedule M—Bequests, etc., to Surviving Spouse	20	
21	Schedule O—Charitable, Public, and Similar Gifts and Bequests	21	
22	Tentative total allowable deductions (add items 17 through 21). Enter here and on line 2 of the Tax Computation	22	

Print

Form 706 (Rev. 9-2009)

Estate of: | **Decedent's Social Security Number**

SCHEDULE A—Real Estate

- For jointly owned property that must be disclosed on Schedule E, see the instructions on the reverse side of Schedule E.
- Real estate that is part of a sole proprietorship should be shown on Schedule F.
- Real estate that is included in the gross estate under section 2035, 2036, 2037, or 2038 should be shown on Schedule G.
- Real estate that is included in the gross estate under section 2041 should be shown on Schedule H.
- If you elect section 2032A valuation, you must complete Schedule A and Schedule A-1.

Item number	Description	Alternate valuation date	Alternate value	Value at date of death
1				
	Total from continuation schedules or additional sheets attached to this schedule . . .			
	TOTAL. (Also enter on Part 5—Recapitulation, page 3, at item 1.)			

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)
(See the instructions on the reverse side.)

Comment: Note that the remaining Schedules and Instructions to IRS Form 706 are not reprinted here. Form 706,

revised in September 2007, should be used for decedents dying after December 31, 2006, and before January 1, 2008. Form 706, revised in August 2008, should be used for decedents dying after December 31, 2007, and before January 1, 2009. Separate, detailed instructions for completing the form are available from the Internal Revenue Service. Form 706 and its instructions are also available for downloading and printing at the IRS website at http://www.irs.gov. The attorney should review the appropriate version of this form and all instructions before beginning to prepare the return, even if he or she has previously prepared this type of return. IRS Form 706NA, as of this publication last revised in August 2008, should be used for a nonresident alien decedent dying after December 31, 2007.

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2. Filing Requirements

§12.9 a. Which Estates Must File Return

Under IRC §6018, a federal estate tax return must be filed on Form 706 for the estate of every U.S. citizen or resident whose gross estate, valued as of the date of death, plus adjusted taxable gifts after 1976 and specific exemptions, exceeds the applicable exclusion amount under IRC §2010(c) for the calendar year in which the decedent's death occurs. See §12.55 for discussion of applicable exclusion amount.

An entirely different IRC §6018, reflecting elimination of the estate tax by EGTRRA-2001, will go into effect with respect to estates of decedents dying after December 31, 2009, and before January 1, 2011. Under revised IRC §6018, the decedent's estate will be required to file an information return, which will allocate the modified basis step-up available under the new rules in IRC §1022.

A federal estate tax return must be filed on IRS Form 706NA for the estate of every non-U.S. resident who is not a U.S. citizen, but who has a gross estate situated in the U.S. that exceeds $60,000, valued as of the date of death, and adjusted for certain gifts. IRC §6018(a)(2).

PRACTICE TIP: If the estate contains assets having a value that may be disputed and the estate is close to the exclusion amount, a Form 706 or Form 706NA should be filed to start the running of the statute of limitations. Similarly, if establishing values for income tax purposes is important, *e.g.,* to establish basis for gain, loss, or depreciation, it may be desirable to file a Form 706.

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§12.10 b. Who Should File Return

The duly qualified executor or administrator has the nondelegable duty of filing the federal estate tax return; if there are multiple executors or administrators, all must file the return. IRC §6018(a); see IRC §2203. If there is no probate proceeding, however, all persons in actual or constructive possession of the decedent's property are representatives for purposes of preparing and filing the return. IRC §2203. Therefore, several persons, *e.g.,* trustees, surviving joint tenants, and beneficiaries of Totten trusts, may have to file the estate tax return. It is preferable that all these persons coordinate their efforts so that only one return is filed. If they cannot do so, each person in possession of property that is includable in the gross estate must see that the property in his or her possession is reported on a return.

In the following discussion, the term "representative" may be used to describe whichever person (executor, administrator, trustee of revocable trust) is preparing and filing the estate tax return. Other persons preparing the return (*e.g.,* attorney, accountant) also must sign the return under penalty of perjury.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.11 c. When to File Return

§12.11 c. When to File Return

Form 706 must be filed within 9 months after the date of death unless a request for an extension of time to file has been submitted on IRS Form 4768. IRC §6075(a); Treas Reg §§20.6075-1, 20.6081-1.

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§12.12 (1) Extension of Time to File Return; Timely Payment Required

The Internal Revenue Service may grant a reasonable extension of time to file an estate tax return. Except for taxpayers who are abroad, no extension can exceed 6 months. IRC §6081(a).

An estate will be allowed an automatic 6-month extension of time to file if the application, made on IRS Form 4768, is filed on or before the due date (*i.e.,* 9 months from date of death (IRC §6075(a)), the application is filed with the IRS office designated in the application instructions, and the application includes an estimate of the amount of estate tax and GST tax liability and a payment of that estimate. Treas Reg §20.6081-1(a)-(b), (e). The extension is considered "automatic" because the taxpayer need not provide an explanation for why an extension is needed, but the taxpayer still must properly and timely file the extension request in order to obtain the extension. In addition, the IRS may, in its discretion on the showing of good and sufficient cause, grant an extension of time to file the estate tax return if an estate did not request an automatic extension of time to file. Treas Reg §20.6081-1(c).

An extension of time to file does not extend the time for payment of the estate tax due. Treas Reg §20.6081-1(e). Therefore, unless an application for extension of time to pay tax has been requested, the estimated estate tax must be included with IRS Form 4768 at the time it is filed. See *Baccei v U.S.* (ND Cal 2008) 2008-2 USTC ¶60,562, 102 AFTR2d 5801 (penalty imposed on trustee because accountant did not request extension of time to pay on the form and, although a cover letter requested an extension of time to pay, it did not specify the period of the extension sought). If an extension of time to pay the estate tax is also being requested, the amount of the estate tax that can be paid currently must be included. See §12.58 for discussion of requests for late payment. If an extension to file the return is granted but an extension to pay the estate tax is not, interest and late penalties will be assessed on any portion of the tax paid after the due date. Treas Reg §20.6081-1(e).

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§12.13 (2) Late-Filing Penalty

The late-filing penalty is 5 percent of the net tax due for each month (or fraction of a month) the return is late, up to a maximum of 25 percent. This penalty can be avoided if the representative can show reasonable cause for filing late. IRC §6651(a). If an extension of time to file is granted, reasonable cause is generally presumed to exist. If an extension has not been granted, the representative should prepare a detailed statement explaining the reasons for the delay. Treas Reg §301.6651-1(c). However, the estate cannot avoid the penalty for failing to file under the reasonable-cause provisions of IRC §6651 because of reliance on an attorney to file the return. The penalty is avoided only if the representative relied on a mistaken legal opinion that it was unnecessary to file a return. *U.S. v Boyle* (1985) 469 US 241, 83 L Ed 2d 622, 105 S Ct 687 (estate was liable, even though executor expected attorney to comply with filing requirements); *Estate of Gertrude Zlotowski*, TC Memo 2007-203 (estate was liable when there was no evidence that executor received and followed any advice with respect to not making timely return).

If the IRS considers the cause to be reasonable, no late-filing penalty will be assessed. If the return is not filed within 60 days of its due date (including extensions) and reasonable cause has not been shown, the penalty for late filing shall not be less than the lesser of $100 or 100 percent of the net tax due. IRC §6651(a).

If both the late filing and the late-payment penalties apply, the maximum combined monthly penalty is 5 percent. IRC §6651(c)(1). If the penalty for failure to file within 60 days applies, that penalty cannot be reduced below the lesser of $135 or 100 percent of the net tax due. IRC §§6651(a), 6651(c)(1). See §12.59 for discussion of the late-payment penalty. The penalties do not run concurrently; the maximum possible overall penalty is 50 percent. IRC §6651.

For purposes of IRC §6651, a month is defined as the period that terminates with the numerically corresponding date in the succeeding calendar months, and if none, with the last day of the succeeding months. Treas Reg §301.6651-1(b)(2).

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§12.14 d. Where to File Return

Estate and gift tax returns should be filed at the Internal Revenue Service's Cincinnati Service Center, located in Covington, Kentucky. The mailing address for that center is: IRS, Cincinnati, OH 45999. The return can also be hand-delivered to the IRS Service Center by certain private delivery services designated by the IRS (DHL Express, Federal Express, and United Parcel Service).

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3. Estate Tax Valuation

§12.15 a. Appraising Estate Assets

Instructions accompanying the estate tax return are both comprehensive and explicit regarding valuation of the decedent's various assets. When there is no probate, the most significant practical matter facing counsel and the representative of an estate is that of appraising the assets. A reputable independent appraiser can be employed to appraise the specific assets, or a California probate referee can be hired.

Generally, the value to be reported on the return is the fair market value on the date of death. However, the representative may elect to value estate assets as of the alternate valuation date—that is, 6 months after the date of death or, if earlier, at the time of disposition, but only if use of the alternate value both decreases the value of the gross estate and the amount of federal estate tax payable (IRC §2032(c)). See §12.21 for discussion of the alternate valuation date election.

NOTE: If the alternate valuation date is elected, *all* assets must be valued as of the alternate valuation date.

The representative may also elect to value real property used for farming or for purposes of conducting a trade or business, which meets certain special requirements, at a value that reflects its use as farm or business property rather than its fair market value. See §§12.22-12.24 for discussion of the special-use valuation election.

For rules governing the valuation of annuities, unitrust interests, interests for life or term of years, and remainder or reversionary interests, see Temp Treas Reg §§1.7520-1T (income tax), 20.2031-7T (estate tax), and 25.2512-5T (gift tax). For a detailed discussion of valuation, see Drafting California Irrevocable Trusts, chap 6 (3d ed Cal CEB 1997).

If a probate referee has appraised the decedent's assets, counsel may, in most instances, rely initially on that appraisal. If there are difficult valuation problems, however, including the determination of discounts (such as fractional-share, minority-interest, and lack-of-marketability discounts) or premiums (such as control or "swing vote" premiums), and counsel or the client is dissatisfied with the referee's valuation, or a dispute is anticipated over the valuation, counsel should have the client retain an independent appraiser to value the asset, and should attach the appraisal to the return when filed. In any case, the estate-tax-return preparer should review and confirm the values placed on the decedent's property by the referee.

PRACTICE TIP: Real property should be appraised by a professional licensed appraiser. Closely held business interests should always be professionally appraised. In all cases, a copy of the full appraisal report should be filed with the estate tax return.

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§12.16 b. Accuracy-Related Penalties

It is important to value the assets as accurately as possible, because the Internal Revenue Service may impose penalties for underpayments of tax, including both estate tax, if any, and income tax on gains realized when an asset is sold, because the date-of-death value of that asset will establish its basis for purposes of determining the reportable gain at the time of its subsequent sale, exchange, or other disposition. See §§7.30, 14.73. An underpayment of the tax required to be shown on a return is subject to an "accuracy-related penalty" of 20 percent of an underpayment that results from one of the following (IRC §§6662(a)-(b)):

- Negligence or disregard of rules or regulations;
- Any substantial understatement of income tax;
- Any substantial valuation misstatement under Chapter 1 of the Internal Revenue Code (IRC §§1-1400T);
- Any substantial overstatement of pension liabilities; or
- Any substantial estate or gift tax valuation understatement.

A substantial valuation misstatement will occur if the value of the property or adjusted basis for the property claimed on any return of tax imposed under Chapter 1 of the Internal Revenue Code (*i.e.,* a substantial overstatement of the date-of-death value for the property, which becomes its new basis for income tax purposes) is 150 percent or more of the correct amount, if that valuation results in an underpayment of more than $5000 ($10,000 for corporations other than S corporations). IRC §6662(e). For estate and gift tax purposes, substantial valuation understatements are valuations that are 65 percent or less than the amount determined to be correct, if the valuation results in tax underpayments of more than $5000. IRC §6662(g). Higher penalties are provided for "gross valuation misstatements," which, in this context, include valuations on any return of tax imposed under Chapter 1 of the Internal Revenue Code that are 200 percent or more of the correct amount, or that are 40 percent or less than the amount determined to be correct for estate or gift tax purposes. IRC §6662(h)(2)(C). The penalty for a gross valuation misstatement is increased from 20 percent to 40 percent of the portion of the tax underpayment attributable to the misstatement. IRC §6662(h)(1).

The accuracy-related penalty is not imposed with respect to any portion of an underpayment if a reasonable cause exists for the underpayment and the taxpayer acted in good faith with respect to such portion. IRC §6664(c)(1). If applicable, the reasonable cause exception allows the taxpayer to avoid even the 20-percent penalty for underpayment regardless of the extent of the valuation misstatement. However, for income tax purposes, the reasonable cause exception does not apply to a gross valuation overstatement with respect to charitable contribution property and it applies to a substantial valuation overstatement only if the taxpayer made a good faith investigation of the value of the property in addition to obtaining a qualified appraisal. IRC §6664(c)(2). The extent of the taxpayer's effort to assess the proper tax liability is the most important factor in determining whether the taxpayer acted with reasonable cause and in good faith; however, reliance on the advice of a professional tax advisor or appraiser does not necessarily demonstrate reasonable cause. Treas Reg §1.6664-4(b). See Treas Reg §1.6664-4(c) for factors required to demonstrate reasonable reliance on the advice of a professional tax advisor or appraiser. See also *Estate of Thompson v Commissioner* (2d Cir 2007) 499 F3d 129, cert denied (2008) ___ US ___, 171 L Ed 2d 863, 128 S Ct 2932 (decedent's estate did not demonstrate good faith and reasonable reliance on lawyer and accountant when reported estate tax value of close corporation stock was only 15 percent of value determined by court). In addition, appraisers are subject to penalties (up to $1000 or 125 percent of the appraisal fee) if there is either a substantial or gross valuation misstatement. IRC §6695A. Tax return preparers, which may include attorneys who prepare documents used in the preparation of the return, are also subject to penalties (up to $1000 or 50 percent of the income derived by the preparer) for an understatement of tax due to an unreasonable position taken on the return. IRC §6694(a). See §11.3A.

Under IRC §7517, the IRS must, on request, furnish the representative with a written statement explaining the methods of valuation and computation of tax, as well as a copy of any expert appraisal made by or for the IRS. That section applies to estate tax, gift tax, and generation-skipping transfer tax computations and valuations.

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§12.17 c. Revaluation of Previously Reported Gifts

Gifts made after August 5, 1997, may not be revalued by the IRS for estate-tax purposes after the 3-year gift tax statute of limitations has expired, if the value of the gift is adequately disclosed on a gift tax return (IRS Form 709) or a statement attached to a gift tax return. IRC §§2001(f), 6501(a). However, IRC §6501(c)(9) provides that the statute of limitations never runs for any gift that is not adequately disclosed on a gift tax return or an attachment to a return. Counsel should be sensitive to gifts made before death that were not reported because they were within the annual gift tax exclusion or were "inadequately disclosed" on Form 709. For regulations on what constitutes adequate disclosure, see Treas Reg §§20.2001-1(b), 301.6501(c)-1(f).

Taxpayer disputes with the IRS over the revaluation of a gift disclosed on Form 709 can be litigated in a declaratory relief action filed in the Tax Court. IRC §7477. The taxpayer must exhaust all administrative remedies within the IRS before filing the pleading. IRC §7477(b)(2).

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§12.18 4. When Estate Includes Community Property

Only the decedent's half-interest in community and quasi-community property is included in the gross estate. If the representative is taking the position that property held in joint tenancy is community property, he or she should not use joint tenancy rules to confirm title to the entire property in the surviving spouse and should report it as community property in the appropriate schedule for the particular asset, and not as a joint tenancy asset on Schedule E.

Generally, when the estate contains community property, the estate will be permitted to deduct 100 percent of the funeral expenses and expenses of last illness of the decedent, even though paid from community property, under IRC §2053. See IRC §2053(a); Prob C §11446. Otherwise, expenses attributable to community property will be allocated between the deceased spouse's share and the surviving spouse's share for purposes of determining the portion that may be deducted by the deceased spouse's estate for federal estate tax purposes under IRC §2053. The proration and deductibility of debts and expenses for federal estate tax purposes depends on state law. *Commissioner v Estate of Bosch* (1967) 387 US 456, 18 L Ed 2d 886, 87 S Ct 1776. For discussion of these types of deductions against the gross estate (reported on Schedules J, K, L, and O), see §§12.40-12.44, 12.48.

Counsel should pay careful attention to IRC §642(g), which provides that administrative expenses incurred by the decedent's estate and/or by a trust may be deducted for estate tax purposes under IRC §2053 or on the appropriate fiduciary income tax return for income tax purposes, but not both, and be sure to coordinate with the person preparing the fiduciary income tax return to assure the best usage of these deductions.

If the decedent is personally liable for debt secured by property reported on the estate tax return (*i.e.,* if the value of the property securing the debt falls below the balance due on the debt, and therefore the borrower's other assets may be seized to pay any remaining unpaid balance), the gross value of the asset is reported on the appropriate Schedule A, B, C, D, E, F, G, H, or I, and the balance due on the debt is reported on the appropriate Schedule J, K, or L. However, if the decedent is not personally liable for debt secured by property reported on the estate tax return:

- The net value of the asset (gross value less outstanding balance due on the debt at the decedent's death) rather than the full value is reported on the appropriate Schedule A, B, C, D, E, F, G, H, or I, and
- The balance due on the debt is not reported on Schedule J, K, or L (the net effect of which is to disallow a deduction if the debt exceeds the value of the property securing it).

PRACTICE TIP: It is suggested that all community property assets be listed together, with the full fair market value of each community property asset reported in the column opposite the item's description. The surviving spouse's one-half community property interest is subtracted ("Less the surviving spouse's one-half community property interest") at the end of the entire block of assets that constitute the community property on the appropriate schedule. Items that are the separate property of the decedent should be listed and totaled in a separate block.

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§12.19 5. Analysis of Form 706

Generally, the instructions for Form 706 are helpful, as are the various computer programs for preparing estate tax returns. One must know the underlying IRC statutes and regulations, however, and not rely on the IRS's instructions or other information, except as a guide to preparing the return itself.

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§12.20 a. Format of Form 706

If the value of the gross estate, plus the value of adjusted taxable gifts made by the decedent after December 31, 1976, exceeds the applicable exclusion amount (IRC §2010(c)), the personal representative must file the first three pages of Form 706, as well as all schedules that have an entry other than "-0-" on the recapitulation page. Schedule F (Other Miscellaneous Property Not Reportable Under Any Other Schedule) should be prepared and filed, regardless of whether there is an entry in the recapitulation. For further information on the format of the return, see the instructions accompanying Form 706.

If the decedent died testate, a certified copy of the will must be attached to Form 706. If the decedent created an inter vivos trust, a copy of the trust must be attached.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/ b. Elections by Representative/§12.21 (1) Alternate Valuation Date Election

b. Elections by Representative

§12.21 (1) Alternate Valuation Date Election

Under IRC §2032, the representative may elect to value estate assets as of the alternate valuation date, namely, the sooner of 6 months after the date of the decedent's death or, if the property has been distributed, sold, exchanged, or otherwise disposed of within that 6-month period, the date on which the distribution, sale, or other disposition occurred. See Treas Reg §20.2032-1(c) for discussion of what constitutes a disposition. The alternate valuation date election may be made only if the election will decrease both the value of the gross estate and the amount of the net federal estate tax due after the application of all allowable credits. IRC §2032(c).

NOTE: In the case of a typical married couple, when all estate taxes are deferred until the second death, the alternate valuation date election is not available at the first death unless the surviving spouse disclaims a nominal amount of property to trigger estate tax that is then reduced by making the election. See §14.73.

If the alternate valuation is elected, all assets must be valued at the alternate valuation date; however, any decrease in the value of an asset that is due merely to the lapse of time (*e.g.,* patents, debts, bonds, or survivorship annuities) will not be considered. IRC §2032(a)(3). See also Treas Reg §20.2032-1(d)-(f). Proposed regulations would provide that post-death changes in property other than changes in "market conditions" must be disregarded in determining alternate valuation date values. Events that will be disregarded include corporate reorganizations and the effect of transferring some interests in property while retaining others. Prop Treas Reg §20.2032-1(f)(3). See REG-112196-07, 2008-21 Int Rev Bull 1021.

The proposed regulations were issued in response to the decision in *Estate of Herbert H. Kohler*, TC Memo 2006-152, nonacq in Action on Decision 2008-1, in which the court took account of restrictions on new classes of stock received in a reorganization that was designed to force non-family-member stockholders to allow their interests to be bought out. The *Kohler* decision apparently caused the IRS to become concerned that estates might adopt a variety of postmortem tactics to drive down estate tax values. For example, an estate owning a 51-percent controlling interest in a corporation might sell or distribute a 2-percent interest a month after death (causing alternate valuation of the 2-percent interest) and then contend that the estate could separately value the remaining stock without a control premium at the end of the 6-month period. Ironically, the result in *Kohler* would have been the same under the proposed regulations because the estate did not have enough voting power to block the reorganization.

Practitioners should be aware that IRC §2032 protection can be lost when assets "distributed, sold, exchanged, or otherwise disposed of" within the 6-month period must be valued on the date of such events. Suppose that a large securities account in a revocable trust is distributed to Son and Daughter in equal shares shortly after the settlor's death and that the securities account loses much of its value before the end of the 6-month period. Suppose further that Son and Daughter were entitled to the securities account but not the residue of the trust and that the trust instrument charges estate taxes to the residue. The trustee may have a difficult time explaining to the residuary distributees why the trustee risked the loss of IRC §2032 protection by making a fast distribution to Son and Daughter.

On the other hand, losing the protection is sometimes a good thing. If asset values drop to the point that the estate tax has dropped to zero, quick distributions (sales) can provide a strategy for ensuring that the estate tax will remain zero even if the market rebounds. Sales during the 6-month period can also result in loss of the IRC §2032 protection if the proceeds of sale are reinvested in assets that may lose value, but the risk of a significant decline is minimal if the proceeds of sale are invested in cash, bonds, or similar investments, and sales may be necessary for liquidity purposes in preparation for making distributions, paying taxes, and paying administration expenses.

The election, made by checking "yes" to item 1 of Part 3 of Form 706, must be made on the first estate tax return filed for the estate no later than 1 year after the due date, including extensions, and once made it is irrevocable. IRC §2032(d)(1); see also *Estate of Edward H. Eddy* (2000) 115 TC 135. If the alternate valuation date is elected, values as of the date of death and as of the alternate valuation date must be listed on the recapitulation and on all appropriate schedules, which must be attached to the return. See §12.20 for discussion of the schedules that must be attached to

the return. If supporting schedules are required, a brief explanation of the status or disposition of the item as of the 6-month alternate valuation date should be included as part of the description of each item; for example, "not disposed of within 6 months after death," "distributed on [date]," "sold on [date]." Dispositions made between the date of death and the alternate valuation date must be supported by evidence.

NOTE: The representative should pay special attention to the effect that a disposition of estate assets during this 6-month period will have on the value of those assets for estate tax purposes, and should carefully consider whether it is appropriate to dispose of estate assets during this 6-month period.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/ (2) Special-Use Valuation Election/ §12.22 (a) Election Requirements

(2) Special-Use Valuation Election

§12.22 (a) Election Requirements

The representative may elect to value real property used in the operation of a farm or a closely held business on the basis of its actual use in the farm or business ("special-use valuation"), rather than at its fair market value, if certain requirements are met. IRC §2032A. Both the special-use valuation and the alternate valuation date can be elected. See §12.21 for discussion of the alternate valuation date election.

Generally, the requirements for making the election are:

- The decedent must have been a U.S. citizen or resident at death;
- The farm or closely held business must be located in the United States;
- One or more qualified heirs, as defined in IRC §§2032A(e)(1)-(2), must have acquired the business or farm that includes the qualified property;
- The property must have been used in a qualified manner by the decedent or a member of the decedent's family for 5 of the 8 years before the date of death (IRC §2032A(b)(1)(C));
- The adjusted value of the business or farm must be at least 50 percent of the value of the decedent's adjusted gross estate (IRC §2032A(b)(1)(A)); and
- The adjusted value of the qualified property used in the operation of the business or farm must be at least 25 percent of the decedent's adjusted gross estate (IRC §2032A(b)(1)(B)).

The requirements for eligibility to make the election, how to make the election, and how to determine the special-use value are set forth in the regulations under IRC §2032A. The regulations are detailed and complex and should be carefully reviewed if the representative believes some of the decedent's property may qualify for this election. The election, once made, is irrevocable. IRC §2032A(d)(1).

PRACTICE TIP: When the decedent's adjusted gross estate, the value of the business or farm interest, or the value of the real property used in the operation of the business or farm, as determined by the executor/trustee, are such that the estate does not currently qualify for special-use valuation, but might qualify for special-use valuation if those values are changed as a result of an audit, it is possible to make a protective election to use IRC §2032A. See Treas Reg §20.2032A-8(b).

It is not necessary to elect special-use valuation for all property entitled to it; however, the return must include property that is valued under the special-use valuation method in an amount necessary to meet the threshold percentages set forth in IRC §2032A(b). Furthermore, IRC §2032A(a)(2) limits the aggregate decrease in fair market value of all property valued under the special-use valuation method to $750,000. The $750,000 amount is adjusted annually for inflation, and has been increased to $940,000 for decedents dying in 2007, $960,000 for decedents dying in 2008, and $1,000,000 for decedents dying in 2009. IRC §2032A(a)(3); Rev Proc 2006-53, 2006-48 Int Rev Bull 996; Rev Proc 2007-66, 2007-45 Int Rev Bull 970; Rev Proc 2008-66, 2008-45 Int Rev Bull 1107.

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§12.23 (b) Making the Election

The special use valuation election must be made on the first Form 706 filed by answering yes to Question 2 of Part 3 of the return. The description of assets for which the election is being made should include the words "§2032A Valuation." Schedule A-1 and its required attachments must be filed with the return, regardless of the size of the gross estate. If it is unclear whether an election should be made when the return is filed, a protective election can be made by answering yes to Question 2, Part 3 of Form 706 and so indicating on Schedule A-1. See §12.24 for discussion of Schedule A-1. If the protective election is made, the fair market values of the properties should be used when preparing the return and tax should be paid as shown on the return. The tax may be higher than the tax that will ultimately be payable if, due to changed asset values resulting from an IRS audit, special-use valuation becomes available to the estate.

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§12.24 (c) Schedule A-1 (IRC §2032A Valuation); Recapture Provisions

If the representative elects to value qualified property at the value determined on the basis of its special use, Schedule A-1 must be filed with the return. The purpose of Schedule A-1 is to identify the qualified heirs and the amount of qualified property each of them has received and to include their agreement to the recapture of the estate tax under IRC §2032A(c). Generally, the recapture provisions apply if, within 10 years after the decedent's death and before the qualified heir's death, the interest in the business or farm is distributed to a nonqualified heir or if the property is no longer used for a qualified purpose. The recapture tax is chargeable to the "qualified heirs" (including remainder beneficiaries of the trust) in proportion to their respective interests in the property. *Estate of Libeu* (1988) 205 CA3d 1436, 253 CR 456.

Besides Schedule A-1, a notice of election and a recapture agreement (contained in Part 3 of Schedule A-1 to Form 706) signed by persons with an interest in property must be filed with the return. The notice requirements are set forth in the instructions to Schedule A-1. The agreement, as required by IRC §2032A(a)(1)(B) and (d)(2), must be executed by all parties who have an interest in qualified property attributable to the decedent consenting to the liability that may be imposed under the recapture provisions of IRC §2032A(c). The instructions to Schedule A-1 and the regulations under IRC §2032A should be consulted for precise instructions on how this agreement should be executed and by whom.

If the protective election is made (see §12.23), the words "protective election" should be written across Schedule A-1 without any further entries on the schedule, which should be filed with the return. When a protective election is made, the representative need not attach the notice of election or the agreement to the return, but must attach a notice of protective election, the requirements of which are set forth in the instructions.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.25 (3) Qualified Family-Owned Business Interests (IRC §2057)

§12.25 (3) Qualified Family-Owned Business Interests (IRC §2057)

NOTE: Internal Revenue Code §2057 does not apply to decedents dying after December 31, 2003 (IRC §2057(j)), so this section addresses only those issues related to the recapture of tax benefits for QFOBIs created on or before that date.

For decedents dying on or before December 31, 2003, IRC §2057 provides a deduction for the adjusted value of "qualified family-owned business interests" (QFOBIs) that were acquired by qualified heirs, whether by transfer from the decedent or by purchase from the decedent's estate or revocable trust. IRC §§2057(b)(2)(B), 2032A(e)(9).

The rules governing QFOBIs required the continued material participation of the qualified heirs in the business after the decedent's death. IRC §2057(f)(1)(A). If the material participation requirements are not met or if any portion of the business is transferred outside the "family" within 10 years after the decedent's death, IRC §2057(f)(2)(A) imposes an "additional estate tax" or recapture tax. The amount of the additional tax is a percentage of the amount of the estate tax that was saved as a result of making the IRC §2057 election, plus interest. For the first 6 years, the percentage is 100 percent. The percentage is 80 percent in the seventh year, 60 percent in the eighth year, 40 percent in the ninth year, and 20 percent in the tenth year. IRC §2057(f)(2)(B).

PRACTICE TIP: If a QFOBI election was made for the estate of a decedent dying on or before December 31, 2003, counsel should calendar the end of the 10-year recapture period and assist the clients with the determination and payment of the additional tax, as appropriate. The recapture tax will cease to be a matter of concern on and after January 1, 2014.

A qualified heir is not treated as disposing of an interest described in §2057(e)(1)(A) (trade or business carried on as proprietorship) by virtue of ceasing to be engaged in the trade or business, as long as a family member continues to use the property in a trade or business. IRC §2057(f)(3).

There are no IRC §6166 installment payment provisions for the "additional estate tax," so the recapture tax will have to be determined and paid immediately following the cessation of such material participation.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.26 (4) Qualified Terminable Interest Property (QTIP) Election

§12.26 (4) Qualified Terminable Interest Property (QTIP) Election

Internal Revenue Code §2056(a) provides an unlimited marital deduction for property transferred from the decedent spouse to the surviving spouse, except as limited by IRC §2056(b) (dealing with the types of interests that will qualify for the deduction) and IRC §2056(d) (dealing with transfers to noncitizen spouses). Internal Revenue Code §2056(b)(7) allows the transfer of "qualified terminable interest property" (QTIP) to qualify for the marital deduction. There are several requirements to qualify property as qualified terminable interest property that will be entitled to claim the marital deduction. An important requirement is that the representative make a timely election under IRC §2056(b)(7). This election must be filed with the estate tax return and is irrevocable. IRC §2056(b)(7)(B)(v). See §12.26A. If the surviving spouse is not a citizen of the United States, transfers to the surviving spouse will not qualify for the marital deduction. However, if certain special requirements are met (IRC §§2056(d), 2056A; see §12.46), a special type of marital deduction may be applied to such transfers, the net effect of which is to defer estate taxes that would otherwise be due from the estate of the first spouse to die until the death of the surviving spouse. See §12.26B.

CAUTION: In one situation, an election to treat a terminable interest as QTIP is automatic and the representative must act in order to avoid having the property treated as qualified terminable interest property. Under IRC §2056(b)(7)(C), an annuity in which only the surviving spouse has the right to receive payments before his or her death, and that is included in the gross estate of the decedent under IRC §2039, will qualify for the marital deduction, and the representative will be treated as having made the election, unless he or she otherwise affirmatively elects not to make such an election on the estate tax return.

The QTIP election is made by listing the qualified terminable interest property on Schedule M and deducting its value. The QTIP election will be deemed to apply to the entire interest in each trust listed on Schedule M unless that schedule clearly reflects the fractional share of the entire interest to which the QTIP election will apply. This means that if a partial QTIP election is being made, the fractional share to which the partial election applies must be clearly indicated on Schedule M. See §§12.45-12.46.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.26A (a) Making QTIP Election on Late or Amended Return

§12.26A (a) Making QTIP Election on Late or Amended Return

If the election is not made at the time the original Form 706 is filed, it can be made on an amended return if filed by the date the original return was due. The IRS has been liberal in allowing late elections when no election was made on the original return. See IRS Letter Rulings 200526017, 200215025. If the election is made on a timely return, it cannot be modified after the expiration of the period for timely filing the return (including extensions). Treas Reg §20.2056(b)-7(b)(4)(ii). For this reason, it is generally preferable to use a formula election (as expressly authorized by Treas Reg §20.2056(b)-7(h), Examples 7-8) so that the marital deduction can be adjusted if property values are disputed or additional property is discovered after the return is filed. In many cases, the Schedule M entry can either restate or incorporate the plan's marital deduction formula clause. For example, it might state:

> The fraction of the residue of the trust estate necessary to reduce the federal estate tax to zero as determined in accordance with the marital deduction formula clause in Article ___, Section ___, of the attached John and Mary Doe Revocable Trust. Dollar amount listed is based on reported values and is subject to change.

However, the IRS has sometimes allowed the QTIP election for later-discovered assets. See, *e.g.*, IRS Letter Ruling 200430002. In IRS Letter Ruling 200832011, the IRS allowed a marital deduction for the correct QTIP election amount even though an incorrect amount was reported on the return because of a calculation error.

If there is no probate estate and no representative is appointed, then the person in actual or constructive possession of the decedent's property is the "executor" (IRC §2203), with the responsibility for filing the estate tax return, and, because he or she is the "executor wherever it is used in this title in connection with the estate tax imposed by [Chapter 11 of the Internal Revenue Code]," he or she is apparently the proper person to make the election.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.26B (b) Inclusion of QTIP Property in Estate of Surviving Spouse

§12.26B (b) Inclusion of QTIP Property in Estate of Surviving Spouse

If a QTIP election is made that was not necessary to reduce the estate tax liability of the first spouse to die, the IRS will disregard the election and treat it as null and void for purposes of IRC §§2044(a), 2056(b)(7), 2519(a), and 2652. Rev Proc 2001-38, 2001-1 Cum Bull 1335. See, *e.g.*, IRS Letter Ruling 200535026 (inadvertent QTIP election for bypass trust was void under Rev Proc 2001-38). Thus, the property will not be included in the estate of the surviving spouse, the spouse will not be treated as making a gift of the property if the spouse disposes of the income interest with respect to the property, and the spouse will not be treated as the GST tax transferor with respect to the property. Relief is not available, however, if a partial election is required with respect to a trust to reduce the estate tax liability and the trustee has made an election with respect to more trust property than is necessary to reduce the estate tax liability to zero or did not clearly indicate that the QTIP election will apply only to a fractional share of the trust listed on Schedule M.

NOTE: The revenue procedure does not prevent the executor from intentionally making a QTIP election for a portion of an eligible bypass trust for which no tax will be due on the death of the surviving spouse in any event, in order to obtain another step-up in basis for the property on the death of the surviving spouse. A return preparer who *intentionally* makes a QTIP election that reduces the estate below the applicable exclusion amount should confirm this intention in an attachment to Schedule M.

If an estate tax return is being prepared at the death of a surviving spouse (*i.e.,* the second death), *making* the QTIP election will only be an issue if the surviving spouse remarried and is survived by the new spouse. Otherwise, the focus at the death of the surviving spouse will be the effect of the previously made QTIP election on the survivor's estate. The practitioner should review any federal estate tax return filed by the estate of a previously deceased spouse to determine whether an election was made under IRC §2056(b)(7) to treat any property transferred into a trust with income for life to the surviving spouse as qualified terminable interest property. The value of any property that was the subject of that election and that is still held by the trust for which the QTIP election was made on the surviving spouse's death must be included in the surviving spouse's gross estate at its then fair market value for purposes of determining the federal estate taxes due from the surviving spouse. IRC §2044. On recovery of the tax by the surviving spouse's estate, see §12.26C.

Property that is owned by the surviving spouse, individually or in a "survivor's" trust, is not aggregated with QTIP property for purposes of *determining the value* of the property subject to federal estate taxes at the surviving spouse's death. *Estate of Harriett R. Mellinger* (1999) 112 TC 26, acq 1999-2 Cum Bull 763. This can be important if fractional interests in property are owned by the trustee of the QTIP trust, the trustee of a "survivor's" trust, and/or the surviving spouse individually, because discounts for minority or fractional-share ownership may be available.

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§12.26C (c) Recovery of Tax on QTIP Property

Unless the surviving spouse's will or a revocable trust created by the surviving spouse provides otherwise, the estate tax attributable to the inclusion of the QTIP in the surviving spouse's estate may be recovered from the person(s) receiving the property to which the QTIP election applied (namely, the remaindermen of the QTIP trust). See IRC §2207A(a)(1); Treas Reg §20.2207A-1(a)(1). See §12.61 regarding recovery of additional tax. However, a surviving spouse for whom a QTIP trust has been established may direct in his or her will or revocable trust that the estate tax attributable to the inclusion of the QTIP property in his or her estate shall be payable from some other source and not recoverable from the person(s) to whom the assets held in the QTIP trust are distributed following the surviving spouse's death. See IRC §2207A(a)(2); Treas Reg §20.2207A-1(a)(3). The will or revocable trust must specifically indicate the intention to waive the right of recovery, preferably by specific reference to IRC §2207A, because the legislative history of the statute states that a general provision specifying that all taxes are to be paid by the estate is not sufficient to waive the right of recovery. See *Eisenbach v Schneider* (Wash App 2007) 166 P3d 858. Although the Internal Revenue Code provides no procedure to recover the tax from the persons receiving the QTIP property, the surviving spouse's estate appears to have a specifically enforceable claim against the person receiving the property for that reimbursement. See Treas Reg §20.2207A-1(a)(1); see also Prob C §§20110(b)(2), 20117(c).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.27 (5) Election to Make Installment Payments Under IRC §6166

§12.27 (5) Election to Make Installment Payments Under IRC §6166

If the decedent was a U.S. citizen or resident and the estate consists of an interest in a closely held business that is more than 35 percent of the adjusted gross estate, the representative may elect to pay the tax due on the estate tax return in two to ten installments, which must begin no more than 5 years from the date the payment of the estate tax is due (IRC §6166(a)); however, interest accruing on the unpaid estate tax must be paid annually during the first 5 years, and thereafter annually with each installment of the deferred estate tax (IRC §6166(f)). This is a form of tax relief to small business owners. For these purposes, a small business owner may include a partner in a partnership with as many as 45 partners (IRC §6166(b)(1)(B)(ii)) or a shareholder in a corporation with as many as 45 shareholders (IRC §6166(b)(1)(C)(ii)), as well as any partner or shareholder if 20 percent or more of the total capital interest of the partnership (IRC §6166(b)(1)(B)(i)) or 20 percent or more in value of the voting stock of the corporation (IRC §6166(b)(1)(C)(i)) is included in the decedent's gross estate.

Using this election, the beneficiaries of such businesses need not liquidate the business to satisfy the estate tax obligation 9 months from date of death but, instead, can continue to operate the business and make the tax payments over time, from profits. The last payment can be due as late as 14 years after death. The interest rate for this form of relief is statutorily low, namely 2 percent on estate tax attributable to the first $1 million of value of the closely held business, as adjusted for inflation ($1,330,000 in 2009) and reduced by the IRC §2010 applicable exclusion amount, and 45 percent of the current deficiency rate payable under IRC §6621 on the balance of estate tax attributable to the closely held business. See IRC §6601(a), (j).

The election is made by checking yes in item 3 of Part 3 of Form 706. By making the election, the representative agrees to furnish a bond or consent to a special lien under IRC §6324A. In *Estate of Edward P. Roski, Sr.* (2007) 128 TC 113, however, the court held that the IRS had no authority to require every estate making the installment payment election to provide a bond or special lien as security for the deferred tax. In Notice 2007-90, 2007-46 Int Rev Bull 1003, the IRS issued interim guidance in advance of regulations that would set standards to be applied on a case-by-case basis in determining whether a bond or lien will be required to qualify for the election. The election must be made no later than the time prescribed for filing the return (IRC §6166(d)) and must include the information required by Treas Reg §20.6166-1(b). A worksheet to help determine how much of the estate tax may be paid in installments is provided in Instructions for Form 706, p 11 (Rev. September 2009).

The IRS has since issued additional guidance in the form of a program manager technical advice (PMTA) memorandum. PMTA 2009-046, 2009 TNT 129-21, Tax Analysts Doc No. 2009-15307. The memorandum addresses a variety of issues concerning requirements for bonds and liens in the future. Significant positions stated in the memorandum include the following:

- The amount of bond required by the IRS in its discretion may include interest that will be payable in the future in an amount not exceeding the amount of the deferred tax.
- Consistent with the *Roski* decision, the IRS can require a bond or lien in an amount less than the maximum amount.
- The Office of Appeals has authority to make valuation determinations concerning the adequacy of the value of property securing liens.
- For purposes of determining the adequacy of the value of property that will secure liens, the property is to be valued as of the date payment of the estate tax was due, including extensions, and the values are to be reduced by amounts of other encumbrances. Generally, the property will receive a discounted value for these purposes if it received a discounted value for purposes of computing the value of the estate.
- The property used to secure the lien need not be property that was included in the estate.

If the representative does not know at the time of filing the return whether installment payments can be made, he or she can make a protective election with a timely filed federal estate tax return by filing a notice of protective election. Treas Reg §20.6166-1(d). A more limited election (installments beginning on the due date; no 2-percent rate) is

available for estates that fail to meet either the 45-owner test or the 20-percent test if the partnership interests or stock are not readily tradable and the aggregate interests of the estate and the decedent's family in the partnership or corporation exceed 20 percent. IRC §6166(b)(7); IRS Letter Ruling 200529006.

Under IRC §6166(b)(9)(A), installment payment treatment is not available for "passive assets," defined in IRC §6166(b)(9)(B) as any assets that are not "used in carrying on a trade or business." In Rev Rul 2006-34, 2006-1 Cum Bull 1171, the IRS issued guidance concerning the factors likely to be relevant in determining whether an interest in real property will be treated as a passive asset rather than property used in a trade or business. In general, the ruling compares the level and types of services performed by the decedent (or the business entity in which the decedent had an interest) with services performed by independent contractors.

The requirements for claiming IRC §6166 relief can be difficult to meet. Under IRC §7479, it is possible to obtain a declaratory judgment from the Tax Court on whether an estate is eligible to pay (or continue to pay) estate tax in installments under IRC §6166. The requirements for exhausting administrative remedies before seeking Tax Court review are specified in Rev Proc 2005-33, 2005-1 Cum Bull 1231.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.28 (6) Election to Postpone Payment of Tax on Reversionary or Remainder Interests Under IRC §6163

§12.28 (6) Election to Postpone Payment of Tax on Reversionary or Remainder Interests Under IRC §6163

If the gross estate includes a reversionary or remainder interest, payment of the tax attributable to that interest may be postponed for 6 months after the precedent interest (or interests) in the property terminates. IRC §6163(a). The election can be made by checking yes in Question 4 of Part 3 of Form 706. A copy of the instrument under which the interest was created should be filed with the return. Treas Reg §20.6163-1(b). A reasonable extension, not to exceed 3 years, beyond the 6-month period can be requested. IRC §6163(b). There is no equivalent provision for payment of the California estate tax. See §12.68. On accrual of interest, see §11.65.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.29 (7) Land Subject to Qualified Conservation Easement Election

§12.29 (7) Land Subject to Qualified Conservation Easement Election

Under IRC §2031(c), the representative may elect to exclude from the decedent's gross estate up to 40 percent of the value of real property located in the United States that is subject to a qualified conservation easement. The exclusion is reduced if the value of the qualified easement is less than 30 percent of the value of the land (reduced by the value of any retained development rights). IRC §2031(c)(2). The maximum exclusion is $500,000. IRC §2031(c)(3).

The irrevocable election is made on Schedule U of the estate tax return and must be made on or before the due date, including extensions. IRC §2031(c)(6). See §12.52. If the exclusion is claimed, the property does not get a stepped-up basis for income tax purposes. IRC §1014(a)(4).

Conservation easements can be imposed after death by family members or an executor or trustee. IRC §2031(c)(8)(A)(iii), (c)(8)(C). Note that the estate tax exclusion is allowed for an easement granted after death only if no one is allowed an income tax deduction with respect to the easement. IRC §2031(c)(9). If the IRC §2032A special-use valuation has been elected, however, imposition of a conservation easement may trigger the recapture provisions. See §12.24.

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§12.30 c. General Information (Part 4)

The General Information section (Part 4) of Form 706 asks for certain facts about the decedent, the surviving spouse, the beneficiaries, and the estate. If the representative answers yes to any questions in items 9 through 16 of this section, he or she must attach additional information, as described in the instructions to the form.

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d. Schedules for Assets Comprising Gross Estate

§12.31 (1) Schedule A: Real Estate

In general, real estate should be described with its legal description as well as a summary of its attributes (*e.g.,* single-family home or one-bedroom condominium). If there is a street address, it should be reported.

According to the instructions to Schedule A, if the decedent was personally liable for an encumbrance against a given parcel of real estate, the full value of that property is to be reported on Schedule A, and a deduction for the amount of the encumbrance taken on Schedule K. Note that this situation is typical for refinanced homes. If the decedent was not personally liable for the encumbrance, the net value of the property should be shown on Schedule A (*i.e.,* market value minus the encumbrance). In the latter case, the representative should be sure to indicate that the full "equity of redemption value" is shown and that a detailed description of the encumbrance is set forth under the description.

If the decedent owned only a fractional interest in property, this fact should be shown on Schedule A and the representative must answer "Yes" to question 10A of Part 4. See §12.36. The value reported should be the decedent's interest, not the parcel's full value. Computation of the decedent's interest should be shown. Similarly, if the property is encumbered, only the portion attributable to the decedent's interest may be deducted from the value of his or her interest on Schedule A or, when the encumbrance is shown as a separate deduction, on Schedule K.

PRACTICE TIP: If real estate is sold before the estate tax return is filed, it is good practice to attach a copy of the final escrow statement to Form 706.

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§12.32 (2) Schedule B: Stocks and Bonds

For stock, the representative should list the unit value (at market) of the securities; if they are traded on an exchange, which exchange; the class of stock, *e.g.,* preferred or common; and the CUSIP number (or, if applicable, the EIN of the trust, partnership, or closely held entity). If the decedent owned stock in an inactive or closely held corporation, the representative must answer "Yes" to question 10A of Part 4 and provide additional information. See §12.36. Publicly traded stock should be valued at the average of the high and low selling prices on the date of death. If stock is not traded on the date of death, a weighted average of the values on the trading days before and after the date of death should be used. See Treas Reg §20.2031-2(b)(1) for guidance in determining the weighted average value. For bonds, the kind of bond, the maturity date, the interest rate, and the interest-due dates should be shown. See Treas Reg §20.2031-2(b)(2).

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§12.33 (3) Schedule C: Mortgages, Notes, and Cash

Under Schedule C, all mortgages, promissory notes, and cash, including all bank, savings and loan, and credit union accounts, are reported. If the decedent had an interest in a financial account in a foreign country, the representative must answer "Yes" to question 14 of Part 4 of IRS Form 706. A note secured by a deed of trust on real property should so indicate, accompanied by a brief description of the property securing the note. In addition, land sale contracts owned by the decedent should be reported here.

It is important to report any cash found in the decedent's possession at the time of death. Such careful reporting suggests to the estate tax examiner that the person preparing the return has thoroughly examined the decedent's assets and has honestly reported them.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.34 (4) Schedule D: Insurance on Decedent's Life

§12.34 (4) Schedule D: Insurance on Decedent's Life

Life insurance on the decedent's life that is includable in the gross estate under IRC §2042 is reported in Schedule D. Insurance on the life of another owned by the decedent should be reported in Schedule F (miscellaneous property). If any insurance on the decedent's life is omitted from the return, counsel must prepare a complete explanation of why it is not reported. The explanation should be in the form of a declaration under penalty of perjury executed by the person having intimate knowledge of the averred facts.

A life insurance statement (IRS Form 712) must be attached to the return for each policy reported, including policies reported on Schedule F. This form is obtained directly from the insurance company by counsel, the successor owner of the policy (Schedule F), or the beneficiary (Schedule D) as soon as settlement is made. For policies reported on Schedule D, Part 1 of IRS Form 712 will show the exact amount of proceeds paid, to whom paid, and so forth. It will also separately show the amount of accumulated dividends, interest thereon, and postmortem dividends. Dividends that were accumulated and interest that accrued before the decedent's death under the applicable policy must be reported in Schedule D or Schedule F (miscellaneous property), as appropriate. However, dividends that were accumulated and interest that accrued after the decedent's death are not reported on IRS Form 706 but, instead, are reported on the income tax return of the person (IRS Form 1040) or trust (IRS Form 1041) receiving the death benefits payable under any policy on the life of the decedent, or the successor interest to any policy owned by the decedent on the life of another. See §12.36. For policies reported on Schedule F, Part 2 of IRS Form 712 will show the cash value of the policy as of the date of the decedent's death.

In describing a policy on Schedule D, the representative should be sure to show the beneficiary and any outstanding loan against the policy, as well as interest that accrued on that policy before the insured's death. In describing a policy on Schedule F, the representative should indicate who the new owner of the policy will be following the deceased owner's death.

PRACTICE TIP: Counsel should ask the insurance company for Form 712 as soon as possible. The form is not automatically provided, and often several requests are necessary before it is issued. In addition, many insurance companies are unaware of the need to prepare and submit Form 712 for policies that were owned by but did not insure the life of the decedent.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.35 (5) Schedule E: Jointly Owned Property

§12.35 (5) Schedule E: Jointly Owned Property

Under IRC §2040(b)(2), a "qualified joint interest" is any interest in property held by the decedent and the decedent's spouse as joint tenants with right of survivorship, provided the decedent and spouse are the only joint tenants and the surviving spouse is a United States citizen. Only the decedent's one-half interest in qualified joint interest property will be included in the gross estate. The source of the property, the contribution of each spouse, and material participation are irrelevant. Qualified joint interests are reported in Part 1 of Schedule E. In jurisdictions outside California, these provisions also apply to property held by the decedent and the spouse as tenants by the entirety. Most transfers within 3 years before the decedent's death are not brought into the estate. See §12.37.

For property owned jointly by two or more parties, other than a "qualified joint interest," the full value of that property is includable in the deceased owner's gross estate and reported in Part 2 of Schedule E, reduced by the portion attributable to the acquisition costs of the property that the surviving tenants can show they contributed that came from sources other than gifts from the decedent. IRC §2040(a).

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§12.36 (6) Schedule F: Other Miscellaneous Property

All assets of the decedent that have not been shown on the other schedules, *e.g.,* furniture, furnishings, and personal effects, are listed on Schedule F. Schedule F frequently includes the estate's most substantial assets, such as partnership and other business interests, accounts receivable, tax refunds receivable, interest in insurance on the life of another, and IRC §2044 property (QTIP property of a previously deceased spouse; see §12.26). This schedule, as well as Schedule C (mortgages, notes, and cash), may be used to demonstrate counsel's thoroughness in reporting such assets as jewelry, works of art or items with collectible value, and even clothing. The instructions to Form 706 require that Schedule F be filed even if no assets are reported on it. If the decedent owned any interest in a partnership or limited liability company, an unincorporated business, or an inactive or closely held corporation (or a fractional interest in real estate), and the value of the interest is discounted on the return, the representative must answer "Yes" to questions 10a and 10b of Part 4 and refer to the instructions for Schedule F for reporting the total accumulated discounts taken on Schedules A, F, or G.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.37 (7) Schedule G: Lifetime Transfers

§12.37 (7) Schedule G: Lifetime Transfers

Schedule G is designed to pick up gifts made by the decedent during his or her lifetime (*i.e.,* transfers made for less than an adequate and full consideration in money or money's worth), includable in the estate under IRC §§2035-2038. These transfers are described in detail in the instructions, which counsel should study carefully. They may be summarized as follows:

- Gift taxes actually paid by the decedent on transfers made within 3 years of death (IRC §2035(b));
- Transfer made within 3 years of death of a life insurance policy or property interest, if the death benefits under the policy (under IRC §2042) or interest in the property (under IRC §§2036-2038) would have been included in the decedent's estate if it had existed at the decedent's death (IRC §2035(a);
- Transfer of property with a retained life estate, including estate freezes (IRC §2036);
- Transfers taking effect at death (IRC §2037); and
- Transfers with the retained power to alter, amend, revoke, or terminate the transferred interest (IRC §2038).

NOTE: Both IRC §§2036 and 2038 describe property that has been transferred to the typical revocable trust used for estate planning purposes.

Transfers within 3 years of death of property that would otherwise be includable under IRC §2036 (transfers with retained life estate), §2037 (transfers taking effect at death), §2038 (revocable transfers), or §2042 (proceeds of life insurance) are includable in the gross estate and should be reported under item B of Schedule G. IRC §2035(a)(2). Any gift tax paid by the decedent on gifts made within 3 years of death is included in the estate and should be reported under item A of Schedule G. IRC §2035(b). If the decedent made gifts of interests in a partnership or limited liability company (or stock of a closely held corporation) or fractional interests in an unincorporated business in which the decedent retained an interest, and the value of the retained interest is discounted on the return, the representative must answer "Yes" to questions 10a and 10b of Part 4 and refer to the instructions for Schedule F for reporting the total accumulated discounts taken on Schedules A, F, or G.

In addition, transfers made by the decedent within 3 years of death are brought into the estate to determine whether the estate qualifies under IRC §303(b) (distributions in redemption of stock to pay estate taxes), §2032A (valuation of certain farm or real property), §2057 (qualified family-owned business interest deduction), or §6166 (extension of time to pay the estate tax). IRC §2035(c)(2). Gifts made within 3 years of death that would not be includable in the decedent's gross estate under IRC §§2036-2038 or §2042 if held by the decedent at his or her death are only reportable at their date-of-transfer value as "adjusted taxable gifts" on line 4 of Part 2 of IRS Form 706 (rather than taxed in the estate at the date-of-death value).

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§12.37A (a) Treatment of Transfer Made by Decedent to Revocable Trust

If the decedent has transferred title to one or more of his or her assets to the trustee of a revocable trust created by him or her, or if a *Heggstad* petition (see §§13.26, 15.39A-15.40B) will be filed to confirm title to assets in a revocable trust, question 11 and question 12a of Part 4 of Form 706 should be answered "yes." Those assets must be reported under item B of Schedule G, and *not* on the other separate schedules (*i.e.,* real property held by the trustee of a revocable trust will be reported on Schedule G, not on Schedule A). As a practical matter, this can make for a cumbersome Schedule G if there are many assets involved. It is recommended that trust assets listed on Schedule G be categorized in an order and manner that follows the structure of Form 706.

NOTE: If the decedent has transferred interests in partnerships, limited liability companies, or closely held corporations to irrevocable trusts created by the decedent (or in which the decedent had an interest), question 12e of Part 4 of Form 706 must be answered "yes" and the trust EIN must be provided even if the trust assets are not reported anywhere on the return.

If the representative does not believe that the property has been properly transferred to the revocable trust, those questions should be answered "no" and the assets should be reported on the appropriate schedules.

PRACTICE TIP: Despite the instructions, many practitioners report each asset owned by the revocable trust on its appropriate schedule (*e.g.,* real property on Schedule A and stocks on Schedule B, and so forth), claiming that it is easier to prepare and organize the return and that reference to a Part 5 Recapitulation (page 3 of Form 706) prepared in this manner provides a useful "at a glance" summary. If this is done, Schedule G should include a statement similar to the following: "During his lifetime, decedent established the "____ Revocable Trust" (copy attached) and transferred all/virtually all of his assets to it. Each such asset is reported on the appropriate schedule of this return." Anecdotal evidence suggests that estate tax attorneys, on audit, have no problem with this approach.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.37B (b) Treatment of 'Split Gifts'

§12.37B (b) Treatment of "Split Gifts"

If the decedent consented to a "split gift" with the surviving spouse under IRC §2513, and the surviving spouse paid all of the gift tax attributable to that split gift, the gift taxes paid from the surviving spouse's separate property within the 3-year period preceding death would not be included under IRC §2035(a), although gift taxes paid by the surviving spouse on a split gift may be included under the step-transaction doctrine if the decedent gave the spouse money equal to the gift tax. *Brown v U.S.* (9th Cir 2003) 329 F3d 664. However, under IRC §2001(d), if the decedent consented to a split gift with the surviving spouse and the amount of the gift is includible in the decedent's gross estate, any gift tax payable by the surviving spouse on the gift, as determined under IRC §2012(d) (credit for gift taxes paid), is treated as a tax payable with respect to a gift made by the decedent.

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§12.38 (8) Schedule H: Powers of Appointment

One of the most technically complicated aspects of the federal estate tax return involves the includability of powers of appointment possessed by the decedent. If the decedent held a general power of appointment at death, or exercised or released a post-1942 general power of appointment in a manner designed to take effect at the decedent's death, the assets subject to such power are includable as part of the gross estate. IRC §2041(a)(2). The value of this property is reported on Schedule H.

A general power of appointment is a power that is exercisable in favor of the decedent, his or her creditors, his or her estate, or the creditors of his or her estate. IRC §2041(b)(1). A power created on or before October 21, 1942, is not a general power of appointment if it may not be exercised by the donee of the power, acting alone. IRC §2041(b)(1)(B). A power created after October 21, 1942, is not a general power of appointment if it is limited by an ascertainable standard relating to the decedent's health, education, support, and maintenance (IRC §2041(b)(1)(A)) or if it is exercisable by the decedent only in conjunction with the creator of the power or in conjunction with a person with a substantial interest in the property subject to the power that is adverse to that of the decedent (IRC §2041(b)(1)(C)).

If the decedent ever possessed a power of appointment, counsel is advised to carefully read IRC §2041 and the regulations under it. The representative should file a certified or verified copy of the instrument granting, exercising, or releasing a general power of appointment with the return, even if he or she contends that the value of the property subject to the power is not includable as part of the decedent's gross estate. The representative should also review powers of appointment created by the trust on the decedent's death. In some cases, it may be possible to reform a trust to limit the surviving settlor's power to appoint trust property on the survivor's death, which otherwise might cause inclusion of the property in the survivor's estate. See IRS Letter Ruling 200450033.

A more detailed discussion of powers of appointment is beyond the scope of this chapter. See generally California Estate Planning, chap 9 (Cal CEB 2002).

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§12.39 (9) Schedule I: Annuities

In general, Schedule I lists any survivorship or retirement benefits (including IRAs) payable on account of the decedent's death, under any form of commercial or private annuity or contract, other than life insurance, that was entered into after March 3, 1931. Such benefits are includable in the gross estate under IRC §2039. The representative should carefully study the comprehensive instructions for Schedule I, as well as the regulations under §2039, to determine whether any exclusions apply. If the decedent was receiving benefits from an annuity or other contract that terminated entirely at death, so that neither the estate nor any person is entitled to a payment after the decedent's death, that annuity or contract need not be reported.

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e. Schedules for Deductions Against Gross Estate

§12.40 (1) Reporting Deductions

Besides the marital deduction (see §§12.45-12.47) and charitable deduction (see §12.48), the representative may deduct from the gross estate funeral expenses, administration expenses, claims against the estate, encumbrances on property included in the gross estate, and net losses incurred by the estate. IRC §§2053(a), 2054. These deductions are reported on Schedules J, K, and L. See §§12.41-12.44.

Deductions for debts and expenses allowed under IRC §2053(a) may not exceed the value of property subject to claims plus the amount paid out of property not subject to claims by the time for filing of the estate tax return, including any extensions. IRC §2053(c)(2). "Property subject to claims" is determined by local law and is generally property subject to probate administration, but the term as used in IRC §2053(c)(2) does not distinguish between probate and nonprobate assets. *Estate of Snyder v U.S.* (Fed Cl 1999) 99-2 USTC ¶60,357, 84 AFTR2d 5963 (deduction for environmental cleanup costs not limited to value of property in probate estate; revocable trust property subject to claims under Ohio law). Property subject to claims means "property includible in the gross estate of the decedent which, or the avails of which, would bear the burden of the payment of such deductions in the final adjustment and settlement of the estate." IRC §2053(c)(2).

PRACTICE TIP: Assets in a trust, particularly a revocable trust, created by the decedent may be subject to claims if the trust instrument so provides; counsel should carefully examine any trust instrument. Also, assets in a revocable trust subject to the decedent's power of revocation are reachable by creditors of the decedent to the extent that the decedent's probate estate is insufficient to satisfy such claims. Prob C §19001(a).

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(2) Schedule J: Funeral and Administration Expenses

§12.41 (a) Includable Expenses

Funeral expenses should be described and reported under paragraph A of Schedule J. For allowed items of funeral expense, see Treas Reg §20.2053-2. See also *Estate of Sarah M. Davenport*, TC Memo 2006-215 (no estate tax deduction allowed for claimed $3639 expense for "funeral luncheon"). Under California case law, funeral expenses include the costs of "accustomed forms and ceremonies." *Estate of Silverstein* (1984) 159 CA3d 221, 226, 205 CR 294, quoting *Estate of Bauer* (1925) 196 C 757, 759, 239 P 49. Any reimbursements received, *e.g.,* death benefits from social security, should be deducted from the total funeral expenses. The entire net amount of the allowed funeral expenses is deductible, whether those expenses are paid from community or separate property, and whether the estate is probated or not probated. See Prob C §11446. See §12.18 for a general discussion of community property assets and debts.

Expenses incurred in administering property subject to claims should be described and reported under paragraph B of Schedule J. (Administration expenses incurred for property not subject to claims, such as administration expenses incurred in connection with administering assets held by a trust, should be reported on Schedule L, discussed in §12.44.) Administration expenses include the representative's commissions and attorney and accountant fees. The schedule should state whether commissions and fees have been "estimated," "agreed upon," or "paid." If the representative has waived his or her commission, this fact should be stated.

Miscellaneous administration expenses should be described separately under paragraph B(4). These expenses include the appraisal fees, filing fees, expenses for certified copies, and newspaper publication fees. Also included are expenses incurred in preserving and distributing the estate, including the cost of storing or maintaining estate property if the estate cannot be distributed to the beneficiaries immediately. Treas Reg §20.2053-3(d)(1). Specified factors are considered to determine the bona fide nature of claims by family members and related entities. Treas Reg §20.2053-1(b)(2).

The regulations restrict the ability of trustees to deduct contingent and unpaid expenses. Most notably, Treas Reg §20.2053-1(b)(1) establishes a general rule that deductions are not allowable without actual payment unless the regulation concerning "estimated amounts" applies. Under Treas Reg §20.2053-1(b)(4), a deduction is allowed for estimated amounts only if the amount is ascertainable with reasonable certainty and will be paid. Additional restrictions apply to potential and unmatured claims or contested claims and contingent obligations under Treas Reg §20.2053-4(d). However, an important de minimis exception permits the trustee to deduct the current value of unpaid claims when the total amount deducted does not exceed $500,000. Treas Reg §20.2053-4(c). This de minimis rule is expected to reduce the number of protective refund claims that must be filed under Treas Reg §20.2053-1(d). See Notice 2009-84, 2009-44 Int Rev Bull 592. The IRS has asserted that the regulations are needed to produce consistent results among the circuits. TD 9468, 2009-44 Int Rev Bull 570. These "consistent results" also are consistent with common IRS litigation positions that have not enjoyed great recent success in the courts. (Accordingly, the validity of the regulations may be challenged in court.) See §12.43.

In *Kessler v U.S.* (ND Cal 2007) 2007-2 USTC ¶60,544, 100 AFTR2d 5423, the court held that legal fees incurred by nonexecutor beneficiaries in a contest concerning which of two wills should be admitted to probate were not allowable as administration expenses because the will contest did not involve preserving or increasing estate assets. In *Kessler v U.S.* (ND Cal 2008) 2008-1 USTC ¶60,559, 101 AFTR2d 1409, however, the court held that, because one named executor had a duty under California law to offer the will for probate, her fees were properly allowable as administration expenses even though her proffered will was later found to be invalid.

Expenses of selling property are deductible only if the sale is necessary to pay debts, expenses, or taxes or to effect distribution. Treas Reg §20.2053-3(d)(2).

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§12.42 (b) Income Tax Deduction Versus Estate Tax Deduction

Administration expenses allowable under IRC §2053 and losses under IRC §2054 (see §12.44 for discussion of Schedule L) are available as either estate tax or income tax deductions. A double deduction for the same item, however, is not allowed. IRC §642(g).

To take one or more of these deductions on the estate's income tax return instead of the estate tax return, the representative must file a statement and waiver with the estate's fiduciary income tax return (IRS Form 1041) stating that no estate tax deduction for the expense item or items has been taken on IRS Form 706 and that the estate is giving up its right to take the expense deduction for such item or items on IRS Form 706. See IRC §642(g). Once waived, the deduction cannot later be claimed on the estate tax return.

The waiver should be signed by the representative. It can be filed at any time before the income tax year is closed (usually 3 years). Treas Reg §1.642(g)-1. A copy of the statement and waiver should be filed with the estate tax return.

The representative can choose which items to include on which returns and can also take part of one expense on one return and the remainder on the other, if no amounts are duplicated. Note that the double-deduction rule does not apply to items of deduction in respect of a decedent, including interest, taxes, and other expenses, which are allowable as deductions under IRC §2053(a)(3) for estate tax purposes and under IRC §691(b) for income tax purposes. Treas Reg §1.642(g)-2.

NOTE: Funeral expenses may be deducted only on the estate tax return, not on the estate's income tax return. See §12.41.

Counsel should consult with the income tax return preparer regarding the proper return on which to claim these deductions, and should consider deducting these expenses on the income tax return when such treatment would result in better overall tax savings to the distributees of the estate than would result by taking these expenses as estate tax deductions. In deciding whether to make the election, the personal representative must also consider the potentially conflicting interests of the beneficiaries. Electing to take the income tax deduction generally increases the estate tax liability on remainder interests or reduces the amount allocated to remainder beneficiaries under a marital deduction formula clause (see chap 14), because a larger amount must be allocated to the marital deduction qualifying gift to reduce the estate tax to zero; electing to take the estate tax deduction increases the income tax due. In determining whether to take the income tax or estate tax deduction, counsel should review the governing instruments (decedent's will and revocable trust) to see what, if any, provisions are present to deal with the holdings in *Estate of Bixby* (1956) 140 CA2d 326, 295 P2d 58, and *Estate of Bixby* (1958) 158 CA2d 351, 322 P2d 956. See §13.9.

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§12.43 (3) Schedule K: Debts, Mortgages, and Liens

Schedule K is divided into two parts: The top part is for reporting the decedent's debts, and the bottom part is for reporting mortgages and liens, *i.e.,* encumbrances against property included in the gross estate. For discussion of reporting encumbrances, see §12.31.

Debts should be valued in the amount determinable as of the date of death, even if post-death events reduce the amount of that indebtedness. *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248. See also *Estate of Van Horne v Commissioner* (9th Cir 1983) 720 F2d 1114, in which the court allowed a deduction for the present value of the decedent's obligation to pay a monthly sum to a former spouse for the life of the former spouse, based on the spouse's actuarial life expectancy on the date of the decedent's death, without regard to the fact that the spouse died only 6 months after the decedent. But see *Estate of Sachs v Commissioner* (8th Cir 1988) 856 F2d 1158 (no deduction for income tax liability eventually forgiven). More recent decisions have tended to restrict the circumstances in which post-death events can be considered in determining the amount of a deduction for claims against the estate. See, *e.g.*, *Estate of Smith v Commissioner* (5th Cir 1999) 198 F3d 515. In the opinion of the Fifth Circuit, the Ninth Circuit decisions in *Propstra* and *Van Horne* were more consistent with the policy of determining the values of estates as of the date of death to the extent possible. See *Ithaca Trust Co. v U.S.* (1929) 279 US 151, 155, 73 L Ed 647, 650, 49 S Ct 291. See also *Estate of O'Neal v U.S.* (11th Cir 2001) 258 F3d 1265; *Estate of McMorris v Commissioner* (10th Cir 2001) 243 F3d 1254, discussed in §11.82.

Unless the debts result from the decedent's last illness (in which case they are fully deductible under Prob C §11446), the amount of the deduction depends on whether the estate consists of community or separate property, or both. Generally, if the estate consists of all separate, or a mixture of separate and community, property, then the debts are fully deductible; if it consists of all community property, then only half of the debts are deductible. See Prob C §11444 (allocation of debts between estate and surviving spouse).

The decedent's debts include any valid unsecured debt owed by the decedent at the time of death. Only enforceable claims against the decedent, incurred for adequate or full consideration in money or money's worth, are deductible.

PRACTICE TIP: See *White v U.S.* (D Mass 1995) 881 F Supp 688, 692, for authority to report the net value of trust assets on Schedule G (*i.e.,* the value of trust assets reduced by legally enforceable debts to which trust assets were subject on the date of the grantor's death) as an alternative to reporting trust assets on Schedule G or other appropriate schedules (see §12.37) and reporting the debts on Schedule K.

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§12.44 (4) Schedule L: Losses During Administration and Expenses Incurred in Administering Property Not Subject to Claims

Schedule L is also divided into two parts. Net losses during administration are reported in the top part. These losses are limited to casualty and theft losses not compensated for by insurance. When losses are claimed, counsel should indicate which property sustained the loss by referring to the property by schedule and item number.

The lower part of Schedule L is for expenses incurred in administering property not subject to claims, *i.e.,* expenses that would be allowable if the property were subject to claims, such as expenses incurred to administer property held in a revocable trust created by the decedent. IRC §2053(b). See §12.40 regarding what property is not subject to claims. The property for which expense has been incurred must be part of the gross estate. The expenses must have been incurred because of the decedent's death and for the purpose of settling the decedent's interest in the property or in vesting good title to it in the beneficiaries. Treas Reg §20.2053-8. Typical expenses to be reported here are legal fees and administration costs related to administering trust assets, appraisal fees incurred in connection with trust assets, and appraisal and legal fees incurred in connection with joint tenancy assets. In IRS Letter Ruling 200532049, the IRS ruled that an estate could deduct attorney fees in a malpractice action against an attorney who failed to procure timely execution of a disclaimer, which resulted in additional estate taxes. To determine whether trustees' fees for an inter vivos trust created by the decedent are deductible, counsel should consult Treas Reg §20.2053-8(c). See also Treas Reg §20.2056(b)-4(d) regarding the effect of the source of payment of these expenses on the marital deduction. Generally, payment of expenses from the marital deduction qualifying trust, other than management expenses for assets allocated to that trust, will reduce the marital deduction.

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(5) Schedule M: Bequests to Surviving Spouse (Marital Deduction)

§12.45 (a) U.S. Citizen Spouses

An unlimited marital deduction is allowed for transfers of nonterminable interest property to a surviving spouse who is a United States citizen (for example, an outright bequest to a spouse).

An unlimited marital deduction is also allowed for transfers to a "general power of appointment" trust for the benefit of a U.S. citizen spouse (IRC §2056(b)(5)); transfers to a qualified terminable interest property (QTIP) trust for the benefit of a U.S. citizen spouse (IRC §2056(b)(7)); and certain qualifying life interests, *e.g.*, qualifying annuity interests (IRC §2056(b)(6)) and lead interests in a charitable remainder trust (IRC §2056(b)(8)). The attorney should carefully review the provisions of IRC §2056(b) to determine whether any of the interests transferred from the decedent to the surviving spouse are qualifying interests that would enable the estate to claim the marital deduction for those transfers.

QTIP property is listed separately from all other property for which the marital deduction is claimed. In order for property to be eligible for a QTIP election, a qualifying income interest in the transferred property must pass from the decedent to the surviving spouse for life. A qualifying income interest is an interest in which the spouse—and only the spouse—is entitled to all the income, payable at least annually, and in which no one (including the surviving spouse) has a power to appoint any part of that property to anyone other than the spouse during the spouse's lifetime. To the extent that the interest received by the spouse is a qualifying income interest, the marital deduction will be applied to the transferred property subject to the qualifying income interest if the representative makes a QTIP election on the estate tax return. Once made, the QTIP election is irrevocable. IRC §2056(b)(7)(B)(v). See §12.26 for discussion of the QTIP election. The attorney should also review any income interest that the decedent possessed at the time of his or her death to determine whether that interest was a qualified income interest for which a marital deduction had been claimed in the estate of a prior-deceased spouse. Under IRC §2044, the property for which a QTIP election was made in the deceased spouse's estate is includible in the surviving spouse's gross estate. The estate taxes attributable to the inclusion of that property in the surviving spouse's estate are generally recoverable from the QTIP property. IRC §2207A(a)(1). However, under IRC §2207A(a)(2), the surviving spouse may direct the payment of those estate taxes from other sources. See §12.61 for discussion of the recapture provisions.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.46 (b) Non-U.S. Citizen Spouses

§12.46 (b) Non-U.S. Citizen Spouses

A transfer to a surviving spouse who is not a United States citizen will not qualify for the marital deduction available to U.S. citizen spouses unless the surviving spouse becomes a citizen of the United States before the estate tax return is filed, having resided in the United States from the date of death until he or she becomes a citizen. IRC §2056(d)(4). However, a special form of marital deduction, which has the effect of deferring the estate tax otherwise due from the deceased spouse, may be available if the transfer is made in the form of a qualified domestic trust (QDOT). IRC §2056(d)(2)(A).

PRACTICE TIP: The regulations seem to contemplate the ability to claim the traditional marital deduction available to U.S. citizen spouses by delaying the filing of the estate tax return until after U.S. citizenship has been attained. See Treas Reg §20.2056A-1(b), which provides that "a late return filed at any time after the due date is considered filed on the date it is actually filed." But see Treas Reg §20.2056A-1(a)(1)(iii), which effectively limits the period the surviving spouse can delay the filing of an estate tax return to 1 year following the last date on which the return was due, including extensions, if he or she fails to become a U.S. citizen but still wants to transfer assets passing to him or her from the deceased spouse to a QDOT.

A QDOT is a trust in which:

- At least one trustee is an individual citizen of the United States or a domestic corporation (IRC §2056A(a)(1)(A));
- No distributions from the trust may be made without the approval of that citizen-trustee (IRC §2056A(a)(1)(B));
- The requirements of Treas Reg §20.2056A-2 are met (IRC §2056A(a)(2)); and
- An appropriate election has been made under IRC §2056A(a)(3).

The representative must make an election to treat the trust as a QDOT. IRC §2056A(a)(3). The election must be made on the last estate tax return filed before the due date (including extensions) or on the first return filed after the due date, provided that the return is filed not later than 1 year after the due date; once made, the election is irrevocable. IRC §2056A(d); Treas Reg §20.2056A-3(a). If the surviving spouse does not become a U.S. citizen before the date when the estate tax is due, a transfer that is not in the form of a QDOT will qualify for the marital deduction only if:

- The property is transferred or irrevocably assigned to a QDOT before the date when the estate tax return is filed (IRC §2056(d)(2)(B); see Treas Reg §20.2056A-1(b) with respect to late filing of the return; but see Treas Reg §20.2056A-1(a)(1)(iii), which effectively limits the period the surviving spouse can delay the filing of an estate tax return to 1 year following the last date on which the return was due, including extensions); or
- A nonqualifying trust is reformed in a judicial proceeding that is begun before the date when the estate tax is due, including extensions (IRC §2056(d)(5)).

The determination of whether a transfer qualifies as a transfer to a QDOT will be made either as of the date when the estate tax is filed or as of the date when the trust is reformed in a judicial proceeding. IRC §2056(d)(5). Thus, the representative who takes timely action may convert a nonqualifying gift to a noncitizen spouse into a qualifying gift.

WARNING: Be sure to advise the trustee that if distributions of principal are made from the QDOT to the surviving spouse for purposes other than "hardship," those principal distributions will constitute "taxable events" and estate taxes will be due and payable on the amount of principal distributed. See IRC §2056A(b)(1)(A); Treas Reg §20.2056A-5(b)(1), (c)(1). Recall that the trustee has personal liability for any unpaid taxes (including interest and penalties) under 31 USC §3713. See §12.63.

The QDOT tax ceases to apply if the spouse becomes a citizen and the spouse either was a U.S. resident at all times after the decedent's death or no taxable distributions were made from the trust before the spouse became a citizen (Treas Reg §20.2056A-10(a)(1)) and the U.S trustee notifies the IRS and certifies in writing that the spouse has become a U.S. citizen by filing a final Form 706-QDT on or before April 15 of the following year (Treas Reg §20.2056A-

10(a)(2)). If the surviving spouse becomes a citizen but was not a U.S. resident at all times after the decedent's death, and taxable distributions were made from the trust before the spouse became a citizen, the spouse may elect to treat the reduction in the decedent's unified credit under IRC §2010 or §2102(b) for any taxable distributions made before the spouse became a citizen as a reduction in the spouse's gift tax unified credit. See Treas Reg §20.2056A-10(b).

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§12.47 (c) "Savings Clauses" in Probate Code

Probate Code §21522 provides that if the trust instrument contains a gift that the settlor intends to qualify for the marital deduction, then the provisions of the instrument, including the fiduciary's powers, duties, and discretionary authority, shall be construed to comply with the marital deduction provisions of the Internal Revenue Code to conform to the settlor's intent to create a marital deduction gift. The instrument must clearly indicate the settlor's intent that the gift to the spouse will qualify the gift for the marital deduction. *Davis v Commissioner* (9th Cir 2005) 394 F3d 1294; *Estate of Heim v Commssioner* (9th Cir 1990) 914 F2d 1322.

Probate Code §21525 specifically provides that a survivorship requirement for a marital deduction gift shall be construed to limit the survival period to 6 months. In *Estate of Sowder v U.S.* (ED Wash 2005) 407 F Supp 2d 1230, aff'd (9th Cir 2007) 2007-2 USTC ¶60,550, 100 AFTR2d 6379, the district court held that a spousal gift conditioned on survival until distribution qualified for the marital deduction on the basis of extrinsic evidence of the testator's intent under a similar provision of Washington law. The problem may be worse in California because Prob C §25125 does not contain an express authorization to use extrinsic evidence to prove the required intent without first proving ambiguity. In California, extrinsic evidence is provisionally admitted to prove the existence of an ambiguity that will then allow the same or other extrinsic evidence to be admitted to resolve the ambiguity (see *Estate of Kaila* (2001) 94 CA4th 1122, 114 CR2d 865), but proving the ambiguity can be difficult. See, *e.g.*, *Estate of Bert B. Rapp*, TC Memo 1996-10, aff'd (9th Cir 1998) 140 F3d 1211 (extrinsic evidence of intent allowed in case involving California decedent whose will provided for discretionary rather than mandatory distributions of income to surviving spouse, but court concluded that various testator statements concerning marital deduction were insufficient to prove will was ambiguous). If possible, the attorney should attempt to construe the trust to comply with the marital deduction requirements, because a conforming modification of the trust may not be respected for estate tax purposes. See §16.3.

Probate Code §21521 specifically provides, however, that Prob C §§21524 (additional provisions applicable to marital deduction trusts) and 21526 (relieving representatives of liability for good faith decisions about QTIP elections) do not apply to estate trusts. An estate trust is a trust that permits the trustee to pay or accumulate income for the benefit of the surviving spouse for life, but requires the balance that remains in the estate trust at the death of the surviving spouse to be paid to the surviving spouse's estate. See Treas Reg §20.2056(c)-2(b)(1)(iii). See also Rev Rul 72-333, 1972-2 Cum Bull 530 and Rev Rul 68-554, 1968-2 Cum Bull 412.

A complete discussion of the marital deduction rules is beyond the scope of this text. The instructions and the regulations should be studied carefully. See also Drafting California Revocable Trusts, chap 9 (4th ed Cal CEB 2003); California Estate Planning, chap 17 (Cal CEB 2002).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.48 (6) Schedule O: Charitable Deductions

§12.48 (6) Schedule O: Charitable Deductions

The value of assets passing from the decedent either (1) to certain charitable, scientific, literary, religious, educational, and public organizations, or (2) to an employee stock ownership plan (as to certain limited types of transfers) may be deducted from the gross estate. IRC §2055(a). The charitable deduction is allowed for property included in the gross estate that is either transferred by the decedent during his or her lifetime (*e.g.,* assets transferred to a revocable trust) or by the decedent's will. Treas Reg §20.2055-1(a).

CAUTION: The transfer to charity must be directed in the governing instrument signed by the decedent. Thus, if a revocable trust, which becomes irrevocable at death, provides for distribution of tangible personal property to a beneficiary, but the beneficiary directs the trustee to donate the property to a charity, no charitable deduction can be taken on the decedent's estate tax return. For illustrations of this principle when a will is the dispositive instrument, see *Estate of Edna Pearce Lockett*, TC Memo 1998-50; *Sam Broadhead Trust*, TC Memo 1972-196.

If counsel is unsure whether an organization qualifies for the deduction, he or she should ask the organization for a copy of its exemption letter or check IRS Pub 78, Cumulative List of Organizations Described in IRC §170(c), available from the Government Printing Office in Washington, D.C., or from the IRS website at http://www.irs.gov.

A revocable trust that becomes irrevocable at death may provide for creation of a charitable remainder trust, as defined in IRC §664, at the settlor's death either as to a specific amount or as to the residuary trust estate, and the charitable deduction will be available. If the terms are unclear or if the trust instrument includes provisions that would defeat the charitable deduction, and if the trust instrument indicates that the settlor intended, when the trust was executed, to create either a charitable remainder unitrust or a charitable remainder annuity trust, Prob C §21540, which is applicable to any "instrument," provides that the trust shall be construed as complying with the charitable deduction provisions of IRC §2055 and the charitable remainder trust provisions of IRC §664. If the settlor's intent is not clearly indicated in the trust instrument, the trust can be modified to conform to those charitable remainder trust provisions. See §16.19.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.49 (7) Schedule T: Qualified Family-Owned Business Interest (QFOBI) Deduction [Deleted]

§12.49 (7) Schedule T: Qualified Family-Owned Business Interest (QFOBI) Deduction [Deleted]

Beginning with the August 2004 revision of Form 706, Schedule T is omitted because the QFOBI deduction does not apply to estates of decedents dying after December 31, 2003. See IRC §2057(j).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/ f. Schedules for Credits Against Tax/ §12.50 (1) Schedule P: Credit for Foreign Death Taxes

f. Schedules for Credits Against Tax

§12.50 (1) Schedule P: Credit for Foreign Death Taxes

A credit for foreign death taxes may be claimed if an estate tax is paid to a foreign government. IRC §2014. If this credit is claimed, IRS Form 706CE must be attached to the estate tax return to support the claim. The credit is reported on line 13 of Part 2.

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§12.51 (2) Schedule Q: Credit for Tax on Prior Transfers

If the decedent (transferee) received property from a transferor who died within 10 years before or 2 years after the decedent (prior transferor), a credit is allowable for all or part of the federal estate tax paid by the prior transferor's estate on that previously taxed transfer. IRC §2013. If the prior transferor was the decedent's spouse, this credit is not allowed to the extent a marital deduction was allowed. However, if the prior transferor was the decedent's spouse, the decedent (transferee) was not and did not become a U.S. citizen within the applicable time periods, and the decedent (transferee) did not elect to transfer the property received from the prior transferor to a QDOT (see discussion in §12.46), a credit is allowable for all of the federal estate tax paid by the prior transferor's estate on that transfer, regardless of the time period that has elapsed between the death of the prior transferor and the death of the decedent (transferee). IRC §2056(d)(3). To qualify for the credit, the transferred property need not be included or identified in the decedent-transferee's estate. A worksheet for computing this credit is a part of Form 706 instructions; most information needed to complete the worksheet can be obtained from the transferor's Form 706. To receive the credit, Schedule Q must be filed with the return, regardless of the size of the estate. The credit is reported on line 14 of Part 2.

The credit may be especially important if the surviving settlor dies before the return is filed for the deceased settlor. In that case, the representative may elect not to make the QTIP election, with the result that tax is paid in the estate of the deceased settlor and the surviving settlor's estate receives a credit for a portion of the tax based on the value of the income interest in the trust, which reduces the combined tax on the two estates. For discussion of this technique, see Drafting California Revocable Trusts §9.29 (4th ed Cal CEB 2003); California Will Drafting §17.42 (3d ed Cal CEB 1992).

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§12.51A (3) Credit for Pre-1977 Gift Taxes

Line 15 of Part 2 of Form 706 may be used to report the IRC §2012 credit for federal gift taxes paid on certain transfers made before January 1, 1977, that are included in the decedent's gross estate. (The unified credit applies to all gifts made after December 31, 1976. See §12.54.) When taking the credit for pre-1977 gift taxes, the representative should include the credit in the total amount on line 15 (see §12.55C) and identify and enter the amount of the credit on the dotted line to the left of the entry space for line 15 with a notation "section 2012 credit." See Instructions for Form 706, p 6.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.52 g. Schedule U: Qualified Conservation Easement Exclusion

§12.52 g. Schedule U: Qualified Conservation Easement Exclusion

An exclusion is allowed for a qualified conservation easement under IRC §2031(c). Generally, this exclusion is computed by multiplying the value of the property by the "applicable percentage." See §12.29.

Schedule U clarifies the statute, specifying that the exclusion is calculated by using a date-of-death value for the easement (line 5), not the value when the easement was created.

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§12.53 h. Recapitulation: Gross Estate and Allowable Deductions

The totals from Schedules A through I are set forth on the first part of the Recapitulation section (Part 5) on page 3 of Form 706. The total gross estate is arrived at by adding the totals reported on lines 1 through 9 on line 10 and subtracting the qualified conservation easement exclusion (Schedule U; line 11). This figure is carried to line 1 of the Tax Computation section (Part 2) on page 1 of Form 706. If the alternate valuation date is used, entries should be made in both the alternate-value column and the value-at-date-of-death column, but only the total in the alternate-value column is transferred to line 1 of the Tax Computation section. An entry must be made on each of lines 1 through 9 of the Recapitulation section. If any schedule does not have an entry, then "-0-" should be entered on the corresponding line. By entering "-0-" the representative is making a statement, under penalty of perjury, that there are no includable assets for those particular schedules.

The second part of the Recapitulation section requires computation of the total allowable deductions reported in Schedules J through O on lines 13 through 21. The allowable amount of deductions entered on line 17 (which is derived from the Schedule J and K totals entered on line 16) can be no more than the value of property subject to claims or the total expenses and debts paid at the time of filing the return, whichever is greater, but in no event can line 17 be greater than line 16. The total allowable deductions on line 17 and the totals on lines 18 through 21 of deductions reported in Schedules L-O are then added on line 22 and carried to line 2 of the Tax Computation section. See §12.20 for discussion of which schedules must be filed with the return.

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i. Tax Computation

§12.54 (1) Determining Estate Tax

The steps for computing the estate tax are set forth in Part 2, Tax Computation, on page 1 of Form 706. In general, the estate tax is determined by applying the unified rates (see §12.55) to lifetime transfers made by the decedent after December 31, 1976, and the taxable estate, which is calculated by subtracting the IRC §2058 deduction for state death taxes paid to other states from the tentative taxable estate (*i.e.*, total gross estate less total allowable deductions), resulting in a tentative tax from which are subtracted the gift taxes, which would have been paid if computed at the estate rates that apply as of the decedent's date of death, on lifetime transfers made after December 31, 1976. IRC §2001(b)(2).

The net effect of IRC §2001(b)(2) is to disallow any deduction for gift taxes paid at unified gift and estate tax rates that are higher on the date of the gift than those that apply as of the donor's date of death. Special attention must be given to taxable lifetime transfers in excess of $2 million made before December 31, 2006, which were taxable at a marginal gift tax rate that exceeds 45 percent (the maximum estate tax rate for decedents dying in 2007-2009). See §12.2.

The credits allowable to the estate are applied against the resulting gross estate tax. The available credits are:

- The unified credit as adjusted (see §12.55A);
- The credit for state estate taxes (see §12.55B);
- The credit for federal gift taxes on pre-1977 gifts (see §12.51A);
- The credit for foreign estate taxes (see §12.50); and
- The credit for tax on prior transfers (see §12.51).

To determine the decedent's adjusted taxable gifts (line 4) and gift taxes payable on gifts after 1976 (line 7), a worksheet is provided in the instructions. Note that, if any taxable gifts made and reported by the decedent must be included in the decedent's gross estate under IRC §§2035, 2036-2038, 2040, and 2042, the entry for adjusted taxable gifts (line 4) must be adjusted to remove each such gift, at the value reported for gift tax purposes.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.55 (2) Unified Rates and Credits Against Tax

§12.55 (2) Unified Rates and Credits Against Tax

The unified rate schedule is reproduced below. IRC §2001(c). These rates are applied to the taxable estate (line 3c), plus the adjusted taxable gifts (line 4), resulting in the tentative tax (line 6). The tentative tax on line 6 is then reduced by the total gift taxes payable on gifts made after December 31, 1976 (line 7), as discussed in §12.54, and the available estate tax credits, as discussed in §§12.55A-12.55C.

UNIFIED RATE SCHEDULE

If Amount Is:		Tentative Tax Is:		
Above	But Not Above	Tax	+ %	On Excess Above
$ -0-	$ 10,000	$ -0-	18	$ -0-
10,000	20,000	1,800	20	10,000
20,000	40,000	3,800	22	20,000
40,000	60,000	8,200	24	40,000
60,000	80,000	13,000	26	60,000
80,000	100,000	18,200	28	80,000
100,000	150,000	23,800	30	100,000
150,000	250,000	38,800	32	150,000
250,000	500,000	70,800	34	250,000
500,000	750,000	155,800	37	500,000
750,000	1,000,000	248,300	39	750,000
1,000,000	1,250,000	345,800	41	1,000,000
1,250,000	1,500,000	448,300	43	1,250,000
1,500,000	2,000,000	555,800	45	1,500,000
2,000,000	2,500,000	780,800	49	2,000,000
2,500,000		1,025,800	50	2,500,000

In addition, EGTRRA-2001 reduced the top marginal rates for years after 2002 as follows for decedents dying in:

2003	49%
2004	48%
2005	47%
2006	46%
2007-2009	45%

In 2010, EGTRRA-2001 repeals the estate tax but the provision "sunsets" in 2011.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.55A (a) Unified Credit

§12.55A (a) Unified Credit

The applicable credit amount is applied against the gross estate tax (line 10). IRC §2010(a). Instead of stating the credit as a dollar amount, IRC §2010(c) defines the applicable credit amount as the tentative tax that would result if that tax were calculated with respect to the specified applicable exclusion amount. The applicable exclusion amount is phased in depending on the year of death as follows:

Year	*Applicable Exclusion Amount*	*Applicable Credit Amount*
1998	$ 625,000	$ 202,050
1999	650,000	211,300
2000, 2001	675,000	220,550
2002, 2003	1,000,000	345,800
2004, 2005	1,500,000	555,800
2006-2008	2,000,000	780,800
2009	3,500,000	1,455,800
2010	(repealed)	(repealed)
2011 or thereafter	1,000,000	345,800

Under former IRC §2001(c)(2), the tax advantage of the graduated rates for estates of less than $3 million was phased out for taxable estates of decedents dying before 2002 or after 2010 that exceed $10 million. For those estates, a 5-percent "excise tax" was imposed on the amount of the taxable estate that exceeded $10 million but did not exceed $17,184,000, the amount at which the average rate is 55 percent (the tax rate on estates in excess of $3 million under former IRC §2001(c)(1)).

The unified credit is adjusted if any portion of the decedent's pre-1977 lifetime gift exemption of $60,000 was used by the decedent between September 8, 1976, and December 31, 1976. IRC §2010(b). The adjustment (20 percent of the amount of the lifetime gift exemption used between September 8 and December 31, 1976) is entered on line 10 and subtracted from the maximum unified credit (line 9), resulting in the allowable unified credit (line 11). See the specific instructions for line 10 for the credit amount. The allowable credit (line 11) is subtracted from the gross estate tax (line 8), resulting in the estate tax before subtracting other credits (line 12).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.55B (b) State Death Tax Credit

§12.55B (b) State Death Tax Credit

NOTE: For decedents dying on or after January 1, 2005, this credit is repealed and replaced by a deduction for state death taxes actually paid under IRC §2058. To date, California has not adopted either a state estate tax or a state inheritance tax that is determined without reference to the credit under IRC §2011. This means that, in the absence of new legislation, no state estate or inheritance taxes will be due or payable to California, and no state death tax credit or deduction will be available for federal estate tax purposes for decedents dying before 2011.

The state death tax credit (IRC §2011), if applicable, is determined and subtracted at this point. That credit is available to estates of decedents dying before January 1, 2005, and after December 31, 2010, for any estate, inheritance, generation-skipping transfer, or succession taxes paid to any state, but the maximum cannot exceed the amount determined from the table reproduced below, reduced by the applicable reduction for the year of death prior to January 1, 2005. California's estate tax (pick-up tax) qualifies for this credit. See §§12.64-12.69 for discussion of California estate tax. In determining the credit from the table, the representative should remember that it is based on the adjusted taxable estate—that is, the taxable estate (line 3 of Part 2 on page 1 of the August 2004 revision) less $60,000.

COMPUTATION OF MAXIMUM CREDIT
FOR STATE ESTATE TAXES
(IRC §2011(b))

Adjusted Taxable Estate Equal to or		Credit on Amount in Column (1)	Rate of Credit on Excess Over Amount in Column (1)
More Than— (1)	Less Than— (2)	(3)	(4)
-0-	90,000	-0-	0.8
90,000	140,000	400	1.6
140,000	240,000	1,200	2.4
240,000	440,000	3,600	3.2
440,000	640,000	10,000	4.0
640,000	840,000	18,000	4.8
840,000	1,040,000	27,600	5.6
1,040,000	1,540,000	38,800	6.4
1,540,000	2,040,000	70,800	7.2
2,040,000	2,540,000	106,800	8.0
2,540,000	3,040,000	146,800	8.8
3,040,000	3,540,000	190,800	9.6
3,540,000	4,040,000	238,800	10.4
4,040,000	5,040,000	290,800	11.2
5,040,000	6,040,000	402,800	12.0
6,040,000	7,040,000	522,800	12.8
7,040,000	8,040,000	650,800	13.6
8,040,000	9,040,000	786,800	14.4

9,040,000	10,040,000	930,800	15.2
10,040,000	…….	1,082,800	16.0

Under EGTRRA-2001, for decedents dying in the following years, the credit for state estate taxes is reduced as follows, but for decedents dying in 2011 and thereafter the above table will apply:

Calendar Year	Applicable reduction
2002	25%
2003	50%
2004	75%

The allowable credit is entered on line 13 and subtracted from line 12; the result is entered on line 14 (August 2004 revision of IRS Form 706). A new Form 706 will likely be developed and released by the IRS in 2011.

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§12.55C (c) Other Credits

All other credits are subtracted from the amount determined after application of the IRC §2010 unified credit. Specifically, these additional credits include the credit for foreign death taxes (line 13 and Schedule P; see §12.50), and credit for tax on prior transfers (line 14 and Schedule Q; see §12.51), and the credit for federal gift taxes paid on pre-1977 transfers that must be included in the decedent's gross estate (line 15; see §12.51A), with the total amount of all these additional credits being entered on line 15. Line 15 is then subtracted from line 12, resulting in the net estate tax (line 16). Any generation-skipping transfer taxes that may be due as a result of the decedent's death (IRC §§2601-2664 and Schedule R; see §12.56) are entered on line 17 and are added to the net estate tax payable (line 16) to arrive at the total transfer taxes due and payable (line 18). From this total are subtracted any prior payments (explained in an attached statement; see instructions for line 19), resulting in the balance due (line 20). See §§12.57-12.58 for discussion of payment of tax.

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§12.56 (3) Schedules R and R-1: Generation-Skipping Transfer Tax

Schedule R is used to compute the generation-skipping transfer (GST) tax that is payable by the estate. This is a separate tax from the estate tax, although the reporting of the tax, when triggered by death, is done on the estate tax return. Schedule R-1 is used to compute the GST tax that is payable by certain trusts that are includable in the gross estate.

Significantly, Schedule R is also used to allocate the decedent's generation-skipping transfer (GST) tax exemption (initially $1 million under IRC §2631(c), but with indexing for inflation this amount was $1,120,000 for decedents dying in 2003; for decedents dying in 2004-2009, the GST exemption is the same as the applicable exclusion amount under IRC §2010(c); in 2010 the GST tax will be repealed, and starting in 2011 the sunset provision will apply, restoring the GST tax with an exemption of $1,120,000 plus further inflation adjustments for the intervening years). See §12.74 for a discussion of how EGTRRA-2001 has simplified the allocation of exemptions.

NOTE: Read literally, the former statute provides for inflation adjustments from a base year of 1997. Thus, in 2011, the GST tax exemption should be at least $1,120,000, with additional adjustments for the years after 2003. Even if the inflation adjustments were somehow negative from 2003 to 2011, it still makes more sense to use 2003 as a starting point. The revised tables in §§12.2 and 12.74 reflect this assumption.

Only the GST tax that is imposed on "direct skips" must be reported on Form 706. The tax is imposed only on the value of property that is includable in the gross estate and that passes to "skip persons." The Instructions to Form 706 describe how to determine which transfers are direct skips and who are skip persons.

All GST taxes must be reported on Schedule R, unless the Instructions specifically provide that they should be reported on Schedule R-1.

For general discussion of GST tax, see §§12.70-12.78.

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C. Payment of Tax

§12.57 1. When and Where to Pay Tax

Under IRC §6151, the tax must be paid at the time and place fixed for the filing of the estate tax return. Any check or draft should be made out to the Internal Revenue Service. The decedent's social security number should be written on the check and on all correspondence pertaining to the estate tax. The date for paying the tax is ordinarily not extended. But see §12.58.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.58 2. Extension of Time to Pay Tax

§12.58 2. Extension of Time to Pay Tax

Counsel may apply for an extension of time to file the estate tax return or pay the tax on IRS Form 4768. See §12.12 for discussion of extending time to file the return. An extension of time to file the return is not an extension of time to pay the tax. There are basically three provisions for extending the time to pay the estate tax:

- Extensions of time to pay the tax for closely held businesses under IRC §6166 (see §12.27);
- Extensions of time to pay the tax in cases of hardship under IRC §6161; and
- Extensions of time to pay the tax on remainder or reversionary interests under IRC §6163 (see §12.28).

Internal Revenue Code §6161(a)(1) provides for an extension of up to 12 months, and IRC §6161(a)(2) provides for discretionary extensions of time to pay the estate tax, including any part of an IRC §6166 installment payment, for reasonable cause, of up to 10 years.

The extensions granted under IRC §6161 are commonly referred to as "hardship extensions" and are typically used when the estate needs an extension of time to pay the tax for reasons such as lack of liquidity or litigation concerning ownership of property. In addition, IRC §6161(b)(2) provides for discretionary extensions of time to pay any estate tax deficiency for a reasonable period of up to 4 years, provided that the deficiency was not due to negligence, intentional disregard of applicable rules and regulations, or fraud.

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3. Interest and Penalties on Late Payment of Tax

§12.59 a. Penalty for Late Payment of Tax

A late-payment penalty will be imposed if the tax shown on the return is not paid on time and an extension of time to pay the tax has not been granted. The penalty is one-half of 1 percent (*i.e.*, a multiplier of.005) of the net tax due for each month (or fraction of a month) the tax remains unpaid, from the date the tax is due or within 10 days after written demand by the Internal Revenue Service, up to a maximum of 25 percent. IRC §6651(a)(2); Treas Reg §301.6651-1(a)(2)-(3). The.005 penalty increases to 1 percent (.01) for failure to pay the tax that is or should be shown on the return once notice and demand for immediate payment is given under IRC §6331(a) or 10 days after notice of levy is given under IRC §6331(d). IRC §6651(d). The.005 penalty is reduced to.0025 for any month in which an installment payment agreement with the IRS is in effect. IRC §6651(h); Treas Reg §301.6651-1(a)(4).

This penalty is in addition to any interest due on late payment. See §12.60. As with the penalty for late filing, the penalty for late payment can be avoided if reasonable cause for the delay can be shown. See §12.13 for discussion of the late-filing penalty and a reduction of the late-filing penalty if the late-payment penalty also applies.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.60 b. Interest on Late Payment of Tax

§12.60 b. Interest on Late Payment of Tax

Interest will be charged on all estate taxes that are paid after the due date for payment, *even if an extension of time to pay the tax has been granted*, and that interest will accrue from the due date for payment until the date the estate taxes are actually paid. IRC §6601.

If the IRS grants an extension of time to pay the tax for closely held businesses under IRC §6166, the interest charged against the unpaid estate tax will be 2 percent for the first $1 million (plus cost-of-living adjustments) of taxable value (meaning the value in excess of the applicable exclusion amount) and 45 percent of the current deficiency rate of interest under IRC §6621 on the balance of deferred estate tax attributable to the closely held business. IRC §6601(j). The interest charged against the unpaid estate tax in all other circumstances will be the current deficiency rate of interest under IRC §6621, compounded daily. IRC §6601(a).

The interest is in addition to any tax or penalties due. However, interest will be assessed on the estate tax that is not paid on or before the due date, and not on any penalties or additional amounts assessed unless those penalties and/or additional amounts are not paid within 21 calendar days (10 business days if the amount is $100,000 or greater) from the date of the Internal Revenue Service's notice and demand for payment. IRC §6601(e)(2)(A). If interest is assessed on those penalties and/or additional amounts, it will be assessed only for the period from the date of the notice and demand until the date of payment. IRC §6601(e)(2)(A).

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§12.61 4. Recovery of Additional Tax Because of Inclusion of QTIP Assets

Internal Revenue Code §2207A grants to the estate of a surviving spouse, who dies holding an interest in a QTIP, the right to recover from the person(s) receiving the remainder interest in the QTIP the amount of any estate tax that must be paid by the surviving spouse's estate that is attributable to the inclusion of the QTIP property in that estate under IRC §2044. The amount of estate tax that is treated as attributable to the inclusion of the QTIP property in the surviving spouse's estate is determined by subtracting from the estate tax that is due from the surviving spouse's estate (determined including the QTIP property) the amount of estate tax that would be due from the surviving spouse's estate if the QTIP property were excluded from the surviving spouse's gross estate.

Although the Internal Revenue Code provides no procedure to recover the estate tax attributable to the QTIP property from the person(s) receiving that property, the surviving spouse's estate appears to have a specifically enforceable claim against the person receiving the property for that reimbursement. See Treas Reg §20.2207A-1(a)(1); see also Prob C §§20110(b)(2), 20117(c). If the person receiving the QTIP assets refuses to reimburse the estate on demand, the surviving spouse's estate apparently has a cause of action against that person for reimbursement.

NOTE: The will or revocable trust creating the QTIP interest typically provides for the payment of estate taxes attributable to the inclusion of the QTIP interest in the surviving spouse's estate in accordance with IRC §2207A. Counsel should review the instrument creating the QTIP interest to determine whether such a provision is present. For further discussion, see Drafting California Revocable Trusts §15.10 (4th ed Cal CEB 2003).

Internal Revenue Code §2207A(a)(2) allows the surviving spouse to direct in his or her will or revocable trust that the tax attributable to the inclusion of the QTIP property in his or her gross estate shall be paid from some source other than the QTIP property. To accomplish this result, however, the instrument must specifically indicate that the right of recovery with respect to the QTIP is waived (*e.g.*, by specific reference to QTIP, the QTIP trust, §2044, or §2207A). The IRS has ruled that a boilerplate tax apportionment clause directing that all taxes be paid from the residue did not waive the right to recover additional estate taxes attributable to the inclusion of QTIP property. IRS Letter Ruling 200452010. Counsel handling the post-death administration of the second decedent to die (*i.e.*, the surviving spouse) should ascertain whether any such direction has been included in the will and/or any revocable trust executed by the surviving spouse and how that direction impacts the payment of estate taxes that will be due as a result of the inclusion of the QTIP trust in the gross estate of the surviving spouse.

EXAMPLE: To illustrate the operation of the above, consider the situation of the typical blended family: Husband's revocable trust provides that, at his death, a QTIP trust will be created for the benefit of his second Wife, with the remainder to go to the children of his first marriage. Husband dies first. At second Wife's death, all of *her* property passes under her will to her children from her first marriage and all of the property in the QTIP trust passes to Husband's children from his first marriage. The estate tax due from second Wife's estate will be based not only on her property but also on the property that remains in the QTIP trust at second Wife's death. Internal Revenue Code §2207A allows second Wife's estate, including the trustee of a revocable trust created by second Wife that has become irrevocable at her death, to recover the amount of the estate tax attributable to the QTIP trust from Husband's children. However, the law permits second Wife to otherwise provide for the payment of those estate taxes attributable to the QTIP trust in her will or revocable trust.

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§12.62 5. Refund on Overpayment of Tax

A claim for refund for overpayment of estate tax must be filed by the later of 3 years from the due date of the return, or actual filing date, if later, or 2 years from the date the tax was paid. IRC §6511(a). An estate tax return based on estimates starts the running of the statute of limitations under IRC §6511. *Estate of Zeier v U.S.* (9th Cir 1996) 80 F3d 1360, disapproved on other grounds in *First Interstate Bank, N.A. v U.S.* (9th Cir 1997) 108 F3d 1185 (not subject to equitable tolling for taxpayer's mental incompetence). In *Zeier,* the court found that Form 706, filed without the schedules on which the estimated bottom-line values were based, was a specific statement of income and deductions, and served as a valid return.

The amount of the refund is further limited to the portion of the tax paid within 3 years (plus the period of any extension of time for filing the return) before filing the refund claim. IRC §6511(b)(2)(A). Thus, the claim may be disallowed if it is made more than 2 years after the tax is paid or made on a return filed more than 3 years and 6 months after the tax is paid, unless the estate made an earlier informal claim for a refund in communications with the IRS (*Estate of Wilshire v U.S.* (SD Ohio, Nov. 10, 2008, No: 1:07-CV-00377) 2008 US Dist Lexis 91920; *Stevens v U.S.* (ND Cal 2006) 2006-2 USTC ¶60,528, 98 AFTR2d 5184) or the tax payment was specifically designated as a deposit (*Ott v U.S.* (9th Cir 1998) 141 F3d 1306, 1310). The distinction between "payment" and "deposit" applied in the *Ott* decision was established in *Rosenman v U.S.* (1945) 323 US 658, 89 L Ed 535, 65 S Ct 536. In other circuits, a more liberal facts-and-circumstances test is used to determine whether a remittance was a deposit or a payment. See *Blom v U.S.* (ED Pa 2006) 2006-1 USTC ¶60,527, 97 AFTR2d 2777.

If there is an agreement between the Commissioner and the representative to extend the period for assessment under IRC §6501(c)(4), made within the time for filing a claim for a refund, a refund claim may be filed up to 6 months after the extended period for assessment expires. IRC §6511(c).

Interest on refunds is allowed from the date of overpayment to the date of payment of refund at the rate established by IRC §6621 (IRC §6611), but no interest is allowed on a refund paid within 45 days after the last day prescribed for filing IRS Form 706 (determined without regard to any extension of time to file the return) or, for returns filed after that date, the date IRS Form 706 is actually filed. IRC §6611(e)(1). In addition, no interest is allowed on an overpayment from the date a claim is filed until the day the refund is made if the overpayment is refunded within 45 days of filing of the refund claim. IRC §6611(e)(2). If the IRS initiates the refund, the period for which interest on the overpayment accrues is reduced by 45 days. IRC §6611(e)(3).

The time for filing a refund claim specified in IRC §6511(a)-(c) is suspended during any time that an individual is "financially disabled." IRC §6511(h)(1). An individual is "financially disabled" if the individual is unable to manage his or her financial affairs because of a "medically determinable physical *or* mental impairment" that is expected to result in death or that has lasted or is expected to last for a continuous period of not less than 12 months. IRC §6511(h)(2)(A). The limitations period is not suspended during any time when a financially disabled individual's spouse or any other person is authorized to act on behalf of the individual in financial matters. IRC §6511(h)(2)(B). In *Bova v U.S.* (Fed Cl 2008) 2008-1 USTC ¶50,193, 101 AFTR2d 461, the court held that the limitations period was not suspended in a case in which a disabled individual had executed a durable power of attorney prior to the disability, even though there was an oral agreement between the individual and the agent that the power was not to be activated until the disability became apparent, because under state law any contingency postponing the effectiveness of the power must be in writing.

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§12.63 D. Request for Discharge from Personal Liability

The representative may make a written request that the estate tax be determined and that he or she be discharged from personal liability under 31 USC §3713 for payment of federal estate taxes due from the decedent's estate. If the IRS fails to take any action within 9 months after the written request is submitted (or, if the application is submitted before the return is filed, within 9 months after the return is filed), or if the representative pays the amount assessed by the IRS during that 9-month period, he or she will be relieved from personal liability. IRC §2204.

The application for relief from personal liability is made by letter submitted with the return. In addition, although the representative is relieved from personal liability under 31 USC §3713 for payment of estate taxes due from the decedent after the expiration of the 9-month period, additional estate tax can still be assessed against the beneficiaries of the decedent's estate ("transferee liability") until the applicable assessment period expires. See Rev Rul 65-186, 1965-2 Cum Bull 380.

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III. CALIFORNIA ESTATE TAX PROCEDURE

§12.64 A. When Tax Must Be Paid and Return Must Be Filed

Revenue and Taxation Code §13302 imposes a California estate tax ("pick-up" tax) equal to the portion of the maximum allowable amount of the federal estate tax credit for state death taxes paid (IRC §2011) that is attributable to property in California. See §12.55B for discussion of the state death tax credit. Under the present law, the requirement for filing a California estate tax return depends on the need to file a federal estate tax return and the availability of a federal estate tax credit for tax paid; the existence or nonexistence of a probate proceeding is not controlling.

NOTE: For decedents dying on or after January 1, 2005, and before January 1, 2011, the state death tax credit available under IRC §2011 is repealed and replaced by a deduction for state death taxes actually paid under IRC §2058. To date, California has not adopted a state estate tax or inheritance tax that is determined without reference to the credit determined under IRC §2011. This means that no state estate or inheritance taxes will be due or payable to California until after December 31, 2010.

Practitioners should regularly review California law related to estate, inheritance, or other types of death taxes. Without voter approval, however, California cannot enact a tax that is not tied to the federal credit. Cal Const art II, §10(c) (limiting amendments to statutes enacted by initiative).

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B. California Estate Tax Return

§12.65 1. Form: California Estate Tax Return (ET-1)



This form is to be used only for estates of decedents who died on or after June 8, 1982. The return is due and the estate tax is payable nine months after the date of death. ( ) Original ( ) Amended	**CALIFORNIA ESTATE TAX RETURN** CONTROLLER OF THE STATE OF CALIFORNIA DIVISION OF ACCOUNTING AND REPORTING BUREAU OF TAX ADMINISTRATION P.O. BOX 942850 SACRAMENTO, CA 94250-5880	DO NOT USE THIS SPACE

Decedent's Name (First, Middle, Last)	Date of Death

County of Probate (enter N/A if no probate)	Probate Case No. (enter N/A if no probate)	Decedent's Social Security No.

Domicile at Date of Death (City, County, and State or Country) Attach Form IT-2, if domicile claimed is *other than* California.

Name of Representative(s) or Person(s) Filing Return (Executor)	Name of Preparer
Address	Address

Telephone No.	Social Security No.	Telephone No.	Social Security No.

A COPY OF THE FEDERAL ESTATE TAX RETURN, FORM 706, *MUST* BE FILED WITH THIS RETURN

An extension to file the Federal Estate Tax Return has not _____ has _____ been granted until (date) _____.
A true copy of the *approved* federal extension *must* be attached to qualify for a concurrent California extension.

COMPUTATION OF TAX:

1. Total state death tax credit allowable for federal estate tax purposes (see instructions for line 1 on reverse)	**1**	
2. Proration of federal estate tax state death tax credit (complete only if there is property located in states other than California)		
a. Gross value for federal estate tax purposes of property located in California (see instructions for line 2(a) on reverse)	**2(a)**	
b. Gross value of decedent's estate for federal estate tax purposes (IRS Form 706, page 1, line 1)	**2(b)**	
c. Percent of estate for federal estate tax purposes located in California [line 2(a) divided by line 2(b)]	**2(c)**	%
3. Tax payable to California (line 1 multiplied by line 2(c), or the amount from line 1 if no entry on line 2)	**3**	
4. Late filing penalty (5% of line 3 for each month or part thereof from delinquent date of return to date of filing, up to the maximum of 25%)	**4**	
5. Interest due on amount on line 3 from due date of return (nine months after the date of death) to date of payment (see instructions for line 5 on reverse)	**5**	
6. Total tax, penalty, and interest due (total of lines 3, 4, and 5)	**6**	
7. Prior payments (explain in an attached statement)	**7**	
8. Refund due (if line 7 is greater than line 6, subtract line 6 from 7)	**8**	
9. Balance due (if line 6 is greater than line 7, subtract line 7 from 6)	**9**	

PLEASE ATTACH CHECK HERE

MAKE REMITTANCE PAYABLE TO THE CALIFORNIA STATE TREASURER, ATTACH TO THIS RETURN AND MAIL TO THE ADDRESS SHOWN ABOVE

Under penalty of perjury, I declare that I have examined this return, including accompanying attachments and statements, and to the best of my knowledge and belief it is true, correct, and complete. (A declaration of a preparer other than the executor is based on all information of which the preparer has any knowledge.)

Signature(s) of Executor(s)	Date	Signature of Preparer Other than Executor	Date

Print

INSTRUCTIONS FOR CALIFORNIA ESTATE TAX RETURN

GENERAL INFORMATION:

This return must be filed for the estate of every decedent with property in California whose date of death is on or after June 8, 1982, if a Federal Estate Tax Return (IRS Form 706) is required to be filed.

This return must be filed by the personal representative of the estate. "Personal representative" means the personal representative of the decedent or, if there is no personal representative appointed, qualified, and acting within California, any person who is in actual or constructive possession of any property included in the gross estate of the decedent.

DUE DATE: The return is due and any tax liability is payable on or before nine (9) months from the date of death.

A copy of the Federal Estate Tax Return and any approved extensions must be filed with this return.

If an amended Federal Estate Tax Return is filed, an amended California Estate Tax Return must immediately be filed, together with a copy of the amended Federal Estate Tax Return and payment of any additional tax plus interest.

Written notice of final determination of a Federal Estate Tax that contains any adjustments must be given to the State Controller within 60 days of the determination, together with payment of any additional tax plus interest.

SPECIFIC INSTRUCTIONS:

Line 1--For dates of death prior to January 1, 2002, the credit for state death taxes is shown on line 15, Form 706. For dates of death beginning January 1, 2002, the state death tax credit is shown on line 13, Form 706. (Revision date August 2002)

Line 2(a)--Include items of California property from IRS Form 706. Attach a listing of each item and identify the schedule and item number.

"Property located in California" of a California resident includes: real property located in California; tangible personal property having an actual situs in California; and all intangible personal property, wherever the notes, bonds, stock certificates or other evidence, if any, of the ownership of the intangible personal property may be physically located or wherever the banks or other debtors of the decedent may be located or domiciled.

"Property located in California" of a non-resident of California who is a resident of the United States includes real property located in California and tangible personal property having an actual situs in California.

"Property located in California" of a non-resident of the United States includes: real property located in California; tangible personal property having a situs in California; and all intangible personal property in California, including all stock of a corporation organized under the laws of California or that has its principal place of business or does a major part of its business in California, and all stock of a federal corporation or national bank that has its principal place of business or does the major part of its business in California, excluding, however, savings accounts in savings and loan associations operating under the authority of the Division of Savings and Loan or the Federal Home Loan Bank Board, and bank deposits, unless those deposits are held and used in connection with a business conducted or operated, in whole or in part, in California.

Line 4--A like extension to file will be granted if the Internal Revenue Service has granted an extension to file the federal estate tax return.

Line 5--An extension of time to file does not extend the payment due date and does not relieve the payment of interest. Unpaid tax accrues interest from the delinquent date of return to December 31, 1998, at 12% per annum. Subsequent to December 31, 1998, the unpaid tax bears interest at the federal rate for underpayment of tax provided in Section 6621(a)(2) of the Internal Revenue Code (the federal rate). Subsequent to December 31, 2000, the entire unpaid balance bears interest at the federal rate and is compounded daily. You may access the applicable rates on the SCO's Web site at http://www.sco.ca.gov.

Line 6--If a payment is insufficient to cover the total amount due, it will be applied first to interest due, then to penalties, and then to the tax. Subsequent to December 31, 2000, all payments made will be applied to the total unpaid balance due.

PRIVACY NOTIFICATION

The Information Practices Act of 1977 (IPA), California Civil Code Section 1798, and the Federal Privacy Act (FPA), United States Code Sections 366-409, require the State Controller's Office (SCO) to provide the following information to individuals supplying personal or confidential information to this office.

The principal purpose for requesting Estate Tax Return information is to administer the Estate Tax Law of the State of California. This includes the determination and collection of the correct amount of tax.

The California Revenue and Taxation Code requires every individual liable for any tax imposed by the code to file an Estate Tax Return (return) according to the Estate Tax Rules and Regulations prescribed by the State Controller (§§ 13501 and 14103). Individuals filing Estate Tax Returns, statements, or other related documents are required to include their Social Security numbers to provide proper identification and to permit processing of the declarations.

Furnishing all the appropriate information requested on the return and any related data is mandatory. Failure to provide all or part of the requested information may result in the disallowance of claimed exemptions, exclusions, credits, deductions, or adjustments, resulting in increased tax liability, loss or delay in issuance of a refund for overpayment, interest charges on unpaid taxes, and other disadvantages to the taxpayer.

Information furnished on the return may be transferred to other governmental agencies as authorized by law [IPA §§ 1798.24 (e), (f) and (p) (i.e., the U.S. Internal Revenue Service and the State Franchise Tax Board)] and may be examined by other local, state and/or federal officials charged with the administration of any tax law.

For those individuals with outstanding tax liabilities, the total amount due may be disclosed to employers, financial institutions, and/or county agencies for the purpose of collecting the amount owed.

This will be the principal notification under the Information Practices Act and Executive Order No. B-22-76 (1977) concerning the solicitation of information in connection with any tax return or tax liability of an individual.

Individuals have the right to review their own records maintained by the State Controller's Office, Division of Accounting and Reporting, Bureau of Tax Administration.

Division of Accounting and Reporting
Bureau of Tax Administration

P.O. Box 942850
Sacramento, CA 94250-5880

Internet address: http://www.sco.ca.gov
Telephone #: (916) 445-6321

Comment: The form requires jurisdictional information about the decedent (name, address, domicile, social security

number, etc.) and, if the decedent owned property outside California, provides for a proration of the state estate tax credit allowable for federal estate tax purposes.

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§12.66 2. Who Should File Return

The applicable Revenue and Taxation Code sections require that the "personal representative" file the return. Similar to IRC §2203 for the term "executor," Rev & T C §13403 defines personal representative as "any person who is in actual or constructive possession of any property included in the gross estate of the decedent." In many cases, several persons, *e.g.,* trustees of a funded revocable trust created by the decedent, surviving joint tenants, beneficiaries of death benefits payable on life insurance on the decedent's life, beneficiaries of death benefits payable under qualified retirement plans or IRAs, and beneficiaries of Totten trusts, may have to file the California estate tax return. Normally, the person who files the federal estate tax return will be the one to file the California return; but each person in possession of the decedent's property should consider compliance with the filing requirement, because penalties will be imposed on each "personal representative" for failure to file. See Rev & T C §13510. See also §12.10 for discussion of who should file the federal estate tax return.

Imposition of the pick-up tax when the decedent has property located in several states, including California, is governed by Rev & T C §13303, which provides that California is entitled to an amount equal to the IRC §2011 credit multiplied by the quotient of the federal estate tax value of the California property over the federal estate tax value of the gross estate (IRC §2031). "Gross estate" is defined in IRC §2031.

NOTE: For decedents dying before January 1, 2005, and after December 31, 2010, other states may use a different method of apportioning the pick-up tax, and the total pick-up tax paid may exceed the IRC §2011 credit. For decedents dying on or after January 1, 2005, and before January 1, 2011, the credit is repealed and the estate will bear the full amount of state estate taxes paid to other states. See Estate Planning for Special Assets, chap 5 (Cal CEB 2004).

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§12.67 3. Where and When to File Return

For decedents dying before January 1, 2005, and after December 31, 2010, the California Estate Tax Return (Form ET-1) should be mailed with a copy of the United States Estate (& Generation Skipping Transfer) Tax Return (IRS Form 706) to State Controller, Division of Collections, Bureau of Tax Administration, P.O. Box 942850, Sacramento, CA 94250-5880. Note that it should not be sent to the Franchise Tax Board. A check payable to "California State Treasurer" for the amount of tax due should accompany the return.

The return is due 9 months after the date of death. Rev & T C §13501; IRC §6075. Extensions of time for filing the federal return also extend the time for filing the California return. There is no separate form for requesting a California extension of time to file. Copies of the federal return and extension must be filed with the California return. Rev & T C §13502. An extension of time to file does not extend the time for payment of tax. See §12.68.

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§12.68 C. Payment of Tax; Penalties and Interest

The California estate tax is due and payable at the date of the death (Rev & T C §13531) and is delinquent if not paid within 9 months of the date of death (Rev & T C §13532). There is no voucher form for this purpose, so payment should be accompanied by a letter to the State Controller at the address given in §12.67 if an extension of time to file is obtained. The check should be made payable to the California State Treasurer. The decedent's social security number, as well as a reference to the purpose of the payment (*e.g.,* California estate tax), should be written on the check and on all correspondence pertaining to the estate tax.

The penalty for late filing of the California return is 5 percent of the tax due per month (or fraction of a month), not to exceed 25 percent. The penalty is imposed in addition to the interest on late payments. If the late filing is due to reasonable cause, or if the late-filing penalty for the federal return is waived, such waiver shall be deemed to constitute reasonable cause and the California penalty is waived. Rev & T C §13510. It is not possible to defer the payment of tax or make the payments in installments.

Unpaid tax bears interest from the due date of the return at the deficiency rate for federal estate tax purposes provided in IRC §6621 from the date the tax is delinquent to the date it is paid. Rev & T C §13550. Note that the federal rate is subject to change quarterly and is compounded daily.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.69 D. Notice of Final Determination of Federal Tax; Deficiency Determination; Refund

§12.69 D. Notice of Final Determination of Federal Tax; Deficiency Determination; Refund

Within 60 days after final determination of the federal estate tax, the representative must give written notice of that determination to the Controller. Any additional pick-up tax that is due to California and interest on that deficiency must be paid with the notice of final determination. Rev & T C §13504. There is no statute of limitations for deficiency determinations if the return has not been filed or is false or fraudulent. Rev & T C §13517. If the deficiency determination is erroneous, the Controller may, within 3 years, set aside or amend the determination. Rev & T C §13518. Any person who is liable for the tax assessed by an erroneous deficiency may, within 3 years, bring an action to have the deficiency modified. Rev & T C §13520.

Under Rev & T C §13560, a refund is due when the Controller determines that an overpayment has been made. The person desiring a refund must present satisfactory proof to the Controller that a refund is due. Application for refund must be made within 1 year of final determination of the federal estate tax. Rev & T C §13561. Generally, interest on refunds is paid at the rate established in IRC §6621(a)(1) for overpayments. Rev & T C §13563(a). Interest on overpayments for periods is the lesser of 5 percent or the bond equivalent rate of 13-week U.S. Treasury bills computed as simple interest. Rev & T C §13563(b), (c).

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IV. GENERATION-SKIPPING TRANSFER TAX

§12.70 A. Imposition of Generation-Skipping Transfer Tax

A tax (GST tax) is imposed on generation-skipping transfers (GSTs) under Chapter 13 of the Internal Revenue Code (IRC §§2601-2664). In general, the GST tax is imposed on transfers to a "skip person," meaning an individual who belongs to a generation at least two generations younger than that of the transferor, or certain types of trusts (*e.g.,* transfers to trusts benefiting only grandchildren). See §12.78 for discussion of effective dates and transition rules.

Specifically, the GST tax is imposed on (IRC §§2601, 2611):

- Taxable terminations;
- Taxable distributions; and
- Direct skips.

These concepts are discussed more fully in §12.71. There is a special exemption (GST exemption), which exempts from the GST tax transfers of $1 million (plus cost-of-living adjustments) or less, unless the law is amended, in 2011 and thereafter, and transfers of amounts equal to or less than the IRC §2010(c) applicable exclusion amount in 2004-2009. IRC §2631(c). The GST tax does not apply to transfers in 2010. IRC §2664. See §§12.74-12.75 for cost-of-living adjustments to the GST exemption. However, the GST exemption is applied by way of a fraction, called the "applicable fraction," which can cause disastrous results if not properly understood and applied.

As a result of the GST exemption, the GST tax should be relevant only to larger estates. However, for the larger estates, it is important to understand and properly apply the special rules governing the allocation of the GST exemption because transfers made during a decedent's lifetime may and likely will affect the amount of the GST exemption available at death.

The GST tax is a flat tax, tied to the maximum estate tax rate. See §12.74A for discussion of how to calculate the tax. In cases involving direct skips, estate or gift taxes will be due in addition to GST tax. However, in cases involving taxable terminations and taxable distributions, only GST tax will be due.

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.71 B. Definitions for Generation-Skipping Transfer Tax

§12.71 B. Definitions for Generation-Skipping Transfer Tax

The following definitions are important to an understanding of the GST tax:

Skip person. A skip person is (1) a natural person assigned to a generation two or more generations younger than the generation of the transferor, or (2) a trust in which either (a) each beneficiary holding a present interest in the trust is a skip person, or (b) no person holds an interest in the trust and no distributions, including a distribution on termination, may be made to a nonskip person. IRC §2613(a). Whether a trust is a skip person is determined without regard to the entity look-through rules of IRC §2651(f)(2) as they apply to trusts. IRC §2612(c)(2).

Nonskip person. Nonskip person means any person who is not a skip person. IRC §2613(b).

Taxable distribution. A taxable distribution is a distribution from a trust (other than a taxable termination or a direct skip—both defined below) to a skip person. IRC §2612(b).

NOTE: GST tax that is paid on a taxable distribution of income is deductible for federal income tax purposes under IRC §164. However, if any of the GST tax that is due as a result of the taxable distribution is paid from the trust, the GST tax paid constitutes an additional taxable distribution on which GST tax will be due and payable. Treas Reg §26.2612-1(c)(1).

Taxable termination. A taxable termination is any termination of an interest in a trust (whether by death, lapse of time, the release of a power, or otherwise) following which there are no nonskip beneficiaries who have an interest in the trust. IRC §2612(a). A termination is not a taxable termination, however, if immediately after a termination either (1) a nonskip person has an interest in the property, or (2) a distribution may not be made at any time to a skip person. IRC §2612(a)(1). The distribution of a specified portion of trust assets to skip persons on termination of the trust will also be treated as a taxable termination. IRC §2612(a)(2).

If no person has an interest after the termination, a taxable termination will not occur even if distributions could be made to a skip person, if the probability of such distributions is so remote as to be negligible. For this purpose, the probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by actuarial standards that there is less than a 5-percent probability that the distribution will occur. Treas Reg §26.2612-1(b)(1)(iii).

Direct skip. A direct skip is a transfer of an interest in property subject to estate or gift tax that is made to a skip person or a transfer to a trust if no interest in the trust is held by a nonskip person. IRC §2612(c).

NOTE: A direct transfer to the transferor's grandchild will not be subject to GST tax if the predeceased ancestor exception (see §12.72) applies.

Transferor. "Transferor" means the decedent with respect to a transfer subject to estate tax, or the donor with respect to a transfer subject to gift tax. IRC §2652(a)(1). See also Treas Reg §26.2652-1(a)(1). A "transfer" is subject to federal gift tax "if a gift tax is imposed under section 2501(a)." Treas Reg §26.2652-1(a)(2). Although there is some ambiguity in the language of the regulation, it appears that the intent was that annual exclusion transfers or deductible transfers are "subject to" federal gift tax for this purpose. However, the electing spouse of a split gift is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under IRC §2513. Treas Reg §26.2652-1(a)(4), (5), Example 9.

If property is transferred by a married couple as a split gift under IRC §2513, it will be similarly treated for GST tax purposes. IRC §2652(a).

Reverse QTIP election. A special election, known as the reverse QTIP election, is available for purposes of the GST tax concerning qualified terminable interest property (QTIP). If the marital deduction has been allowed under IRC §2056(b)(7) for estate tax purposes with respect to a transfer occurring at death, or under IRC §2523(f) for gift tax purposes with respect to a transfer occurring during the transferor's lifetime, the estate of the decedent or the donor spouse may elect to treat all of the QTIP property transferred as belonging to the transferor spouse for purposes of the GST tax (IRC §2652(a)(3)), even though the donee spouse is treated as the transferor of the QTIP property for estate tax purposes (IRC §2044). If a reverse QTIP election is not made with respect to QTIP property, the donee spouse is

treated as transferor of the QTIP property for GST purposes as well as for estate tax purposes. See §§14.49-14.54.

Interest in property held in trust. A person has an interest in property held in trust if that person

- Has a present right to receive income or principal from the trust;
- Is one to whom the trustee has the present discretion to distribute principal or income (other than a charitable beneficiary); or
- Is a trust that qualifies for the estate tax charitable deduction and is a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled-income fund.

IRC §2652(c).

Inclusion ratio. The inclusion ratio is the means by which the flat rate of GST tax is adjusted to reflect the application of the GST exemption. The inclusion ratio reflects the portion of the transferred interest that is subject to GST tax and is defined in IRC §2642(a) as 1 minus the applicable fraction. The applicable fraction is defined in IRC §2642(a)(2) as a fraction, the numerator of which is the amount of GST exemption allocated to the transfer. The denominator is the value of the property transferred, after certain adjustments for charitable deductions and taxes chargeable to the property used to fund the trust. The "applicable rate" of GST tax is then determined by multiplying the top marginal rate for estate tax purposes by the inclusion ratio. IRC §2602.

Obviously, if the amount of the GST exemption that is allocated to the GST is exactly equal to the value of the property being transferred, the applicable fraction will be 1, the inclusion ratio will be zero, and the GST tax due for that transfer will be zero (typically referred to as "zero" trusts or transfers). In the converse, if none of the GST exemption is allocated to the GST, the applicable fraction will be zero, the inclusion ratio will be 1, and the GST tax due for that transfer will be the top marginal estate tax rate (typically referred to as "one" trusts or transfers). Planners generally aim for zeros and ones; however, even in situations intended to be zeros, errors in the valuation of the property being transferred can result in some GST tax being due. See §12.74.

Estate Tax Inclusion Period (ETIP). An ETIP is the period during which, should death occur, the value of transferred property would be includible (other than by reason of IRC §2035) in the transferor's (or the transferor's spouse's) gross estate. Treas Reg §26.2632-1(c)(2)(i). To the extent that there is a more than 5 percent probability that a lifetime transfer made by the transferor will be included in the transferor's (or his or her spouse's) gross estate (other than under IRC §2035), the GST exemption may not be allocated to the transfer until the ETIP ends. The ETIP ends if either the circumstance that would cause the transferred property to be included in the transferor's (or his or her spouse's) estate is ended or the transferor (or with respect to an ETIP interest held by the transferor's spouse, his or her spouse) dies. Treas Reg §26.2632-1(c)(2)-(3).

The following two definitions apply in determining automatic allocations of the GST exemption under IRC §2632:

Indirect skip. An indirect skip is a transfer of property, other than a direct skip, subject to the gift tax made to a GST trust. IRC §2631(c)(3)(A).

GST trust. A GST trust is a trust that *could* have a GST with respect to the transferor. IRC §2632(c)(3)(B). There are six exceptions to the application of this broad definition spelled out in IRC §2632(c)(3)(B); they should be carefully analyzed as needed on a case-by-case basis. However, the transferor may elect on a timely filed gift tax return to have automatic allocation apply or not apply to any or all transfers to a trust. IRC §2632(c)(5).

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§12.72 C. Generation Assignments

Because the GST tax only applies to transfers to a skip person, the transferee's generation assignment must first be determined. Internal Revenue Code §2651 states the complicated rules governing what generation an individual is assigned to for purposes of the GST tax.

If a person is a lineal descendant of a grandparent of the transferor, his or her generation assignment is determined by comparing the number of generations between the grandparent and the transferor to the number of generations between the grandparent and the lineal descendent. IRC §2651(b)(1). For lineal descendants of the transferor, grandchildren and younger generations will be skip persons to the extent the predeceased ancestor exception does not apply. For lineal descendants of the transferor's parents, grandnieces and grandnephews and younger generations will be skip persons to the extent the predeceased ancestor exception does not apply. If a person is a lineal descendent of a grandparent of a spouse (or former spouse) of the transferor, his or her generation assignment is determined by comparing the number of generations between the grandparent and the spouse to the number of generations between the grandparent and the lineal descendant. IRC §2651(b)(2).

Legal adoptions and relationships of half blood are treated as blood relationships for purposes of determining lineal descendants. IRC §2651(b)(3). However, adoptions may not be recognized for generation assignment purposes if the adoption causes the descendant to have two generation assignments under IRC §2651(f)(1) (*e.g.*, a transferor adopts a grandchild) and the IRS determines that the adoption was primarily intended as a means to avoid GST tax. Treas Reg §26.2651-2. Spouses of transferors and transferors are both treated as being in the same generation, regardless of age differences. IRC §2651(c)(1). The spouse of a lineal descendant of the transferor is treated as being in the same generation as the lineal descendant, regardless of age differences. IRC §2651(c)(2).

All other persons are assigned to a generation based on the number of years by which the transferor's age exceeds that person's age. For example, the issue of a transferor's step-siblings are not lineal descendants of the grandparents of either the transferor or the transferor's spouse. Accordingly, their generation assignment is based on age. IRS Letter Ruling 200150003. A person born within 12½ years of the transferor is assigned to the same generation as the transferor. A person born more than 12½ but not more than 37½ years after the transferor is assigned to the generation immediately following the transferor's generation (a nonskip person). IRC §2651(d). Each generation level thereafter is separated by 25 years, meaning any person who is more than 37½ years younger than the transferor will be a skip person. IRC §2651(d).

Charitable interests in a trust are assigned to the transferor's generation. IRC §2651(f)(3).

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§12.72A D. Predeceased Ancestor Exception to Generation Assignment

If the transferor's child is deceased at the time a transfer is made by the transferor to one or more of that deceased child's children, or to a trust that benefits that deceased child's children, that deceased child's children (the transferor's grandchildren) and their lineal descendants will "move up" one generation for purposes of applying the GST tax under the predeceased-ancestor exception. IRC §2651(e). This means that the deceased child's children will be treated as nonskip persons and the deceased child's grandchildren and younger generations will be treated as skip persons with respect to the transferor.

EXAMPLE: If a transferor's child dies before the transferor transfers property to a grandchild who is the child of the transferor's deceased child, that transfer will be entirely exempt from the GST tax because the transfer will be treated as having been made to a nonskip person.

A transfer will not be subject to GST tax if the transfer documentation or local law provides that the transferred property will pass to the transferor's grandchild if the transferor's child who is the parent of that grandchild fails to survive for a period of up to 90 days following the transfer. Treas Reg §26.2651-1(a)(2)(iii). (This rule also applies to descendants more remote than those of a child of the transferor. IRC §2651(e).) In addition, a *living* descendant will not be treated as deceased for GST tax purposes solely by reason of applicable local law, for example, because of a disclaimer. Treas Reg §26.2651-1(a)(2)(iv).

Under IRC §2651(e), generation assignments will be determined either at the time of the transferor's death, if the transfer occurs at the transferor's death, or at the time an inter vivos transfer becomes complete for gift tax purposes, if the transfer occurs during the transferor's lifetime and is not subject to the estate tax inclusion period (ETIP) rule (see §12.71). Consistent with the general treatment of QTIP trusts for GST purposes, the relevant date for determining whether a descendant has a deceased ancestor will be the date of death of the surviving spouse unless an IRC §2652(a)(3) reverse QTIP election has been made for the trust, in which case the QTIP trust is treated for GST purposes as if the QTIP election had not been made and the relevant transfer date is the date of death of the spouse establishing the QTIP. Treas Reg §26.2651-1(a)(3).

Under a related provision of IRC §2651(e), the predeceased-ancestor exception to the GST tax includes lineal descendants of the transferor's parents (*i.e.,* grandnieces and grandnephews), provided that the transferor had no living lineal descendants at the date of the transfer.

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§12.73 E. Generation-Skipping Transfer Taxable Amount

The GST tax is calculated by multiplying the "taxable amount" (discussed in this section) by the "applicable rate" (discussed in §12.74A). IRC §2602.

The taxable amount is defined differently for each type of GST—taxable distribution, taxable termination, and direct skip. See IRC §§2621-2623.

For a *taxable distribution*, the taxable amount is the amount received by the transferee (plus an amount equal to any GST tax attributable to a taxable distribution) less certain expenses. IRC §2621. More specifically, for a taxable distribution, the amount subject to GST tax is the full value (determined at the time of the distribution) of the property distributed to the skip person, reduced by any expenses incurred by the transferee in connection with the determination, collection, or refund of the GST tax due on that distribution (IRC §2621(a)), and increased by the amount of any GST tax paid out of the trust (IRC §2621(b)). The GST due on a taxable distribution is *tax inclusive*, meaning the GST tax itself is included in the amount on which the GST tax is imposed.

For a *taxable termination*, the taxable amount is the value of property with respect to which the taxable termination has occurred, less certain expenses similar to those allowed under IRC §2053. IRC §2622. More specifically, for a taxable termination, the amount subject to GST tax is the value of property with respect to which the taxable termination has occurred, reduced by deductions for expenses under IRC §2622(b). The deduction available under IRC §2622(b) is similar to the deduction allowed by IRC §2053 (relating to expenses, indebtedness, and taxes of the decedent) that is attributable to the property with respect to which the taxable termination has occurred. The GST tax due for a taxable termination is *tax inclusive*.

For a *direct skip*, the taxable amount is the value of property received by the transferee (without adjustment for any expenses). IRC §2623. More specifically, for a direct skip, the amount subject to GST tax is the value of property received by the transferee, excluding any estate or gift taxes paid in connection with the transfer. IRC §2623. This means that only the net amount passing in the direct skip is subject to GST tax and that the GST tax due on a direct skip is *tax exclusive*, meaning the GST tax itself is not included in the tax base). However, IRC §2515 provides that if the transferor is subject to gift taxes as a result of the direct skip transfer, the amount of GST tax paid by the transferor is included as a part of the gift for purposes of determining the gift taxes payable by the transferor.

The value of property for these purposes is determined as of the time of the GST, and is reduced by the amount of any consideration provided by the transferee. The value of property transferred at death is generally the value for estate tax purposes. IRC §2642(b)(2)(A). The estate's alternate valuation election (under IRC §2032) applies to direct skips included in the transferor's estate and for taxable terminations occurring at death. The special-use-valuation election (IRC §2032A) also applies to direct skips of property included in the transferor's gross estate. IRC §2624(b).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/ F. Allocating Exemption and Computing Generation-Skipping Transfer Tax/§12.74 1. Allocating Generation-Skipping Transfer Exemption

F. Allocating Exemption and Computing Generation-Skipping Transfer Tax

§12.74 1. Allocating Generation-Skipping Transfer Exemption

Chapter 13 of the Internal Revenue Code, dealing with GSTs, is a complex area of the law, and the provisions dealing with the allocation of GST exemption and the calculation of GST taxes due on taxable distributions and taxable terminations—which may occur long after the transfer was made—and on direct skips are particularly complicated. A special exemption from GST tax (the GST exemption) is available to shield some or all of the GSTs from GST tax. However, because the GST exemption is applied by way of a fraction, called the "applicable fraction," it is possible that transfers that were intended to be wholly exempt from GST tax will be subject to some GST tax if and to the extent that the value of the transferred property exceeds the GST exemption allocated by the transferor to the transfer. See §12.74A.

A transferor is limited in the total amount of GSTs that are exempt from tax, but may make several transfers that are subject to the GST tax, both during life and at death. Therefore, the transferor (or the transferor's fiduciary, if the transferor is deceased) is permitted to allocate how much of the exemption he or she wishes to take with respect to any transfer.

The transferor is permitted to allocate the GST exemption during his or her life to any inter vivos GSTs. IRC §2632(a). However, under IRC §2632(b), if the transfer is a direct skip, the unused portion of the GST exemption will automatically be allocated to that direct skip as necessary to make the inclusion ratio zero (*i.e.,* an applicable fraction of 1) unless the transferor elects not to have IRC §2632(b) apply to the transfer on a timely filed gift tax return, IRS Form 709. IRC §2632(b)(3); Treas Reg §26.2632-1(b)(1). In addition, under IRC §2632(c), the unused portion of the GST exemption will next be allocated to any indirect skip to a GST trust (see §12.71) as necessary to achieve a zero inclusion ratio for the trust, unless the transferor elects not to have this automatic allocation rule apply. See IRC §2632(c)(5).

If an allocation other than an automatic allocation is made on a timely filed IRS Form 709, the value of the denominator of the applicable fraction is the value of the transferred asset for gift tax purposes. Treas Reg §26.2632-1(b)(4)(ii)(B). If such an allocation is not made on a timely filed IRS Form 709, the value of the denominator of the applicable fraction is generally the value of the transferred asset on the date the allocation is made. Treas Reg §26.2632-1(b)(4)(ii)(A), 1(b)(4)(iii), Examples 3 and 4. However, the IRS may provide relief from late GST exemption allocations or elections under IRC §2642(g).

At the transferor's death, the deceased transferor's executor is allowed to allocate any unused GST exemption as follows:

- The decedent's dispositive documents may direct or his or her executor may select any allocation on or before the date for filing of IRS Form 706, plus extensions. IRC §2632(a)(1).
- In the absence of allocations made by the decedent or his or her executor, any unused exemption is allocated as follows (IRC §2632(b), (e)):
- First, to any direct skip made by the decedent during his or her lifetime on a "first in/first out" (FIFO) basis (IRC §2632(b)(1)-(2)) unless that transfer will be included in the decedent's gross estate under IRC §§2036-2038, in which case the allocation will be deferred until the expiration of the estate tax inclusion period (ETIP) (IRC §2642(f)(1); Treas Reg §26.2632-1(c)(4)).
- Next, to any testamentary direct skips (IRC §2632(e)(1)(A)). Note that if testamentary direct skips exceed the unused GST exemption, the unused GST exemption will be allocated among those transfers on a prorata basis under IRC §2632(e)(2) and Treas Reg §26.2632-1(d)(2).
- Finally, to any trusts from which taxable distributions and/or taxable terminations might be made at or after the decedent's death (IRC §2632(e)(1)(B)). If the amount transferred to all of these trusts exceeds the unused GST exemption, the unused GST exemption will be allocated among these trusts on a prorata basis under IRC §2632(e)(2) and Treas Reg §26.2632-1(d)(2)).

- Treasury Regulation §26.2632-1(b)(1) explains how to elect out of the automatic allocation of the GST exemption to direct skips.

The amount of GST exemption was initially $1 million under IRC §2631(c), an amount that was later indexed for inflation. EGTRRA-2001 made further changes to the exemption amount. The exemption amounts are as follows:

Year	*GST Tax Exemption*
2001	1,060,000 ($1,000,000 indexed for inflation)
2002	1,100,000 ($1,000,000 indexed for inflation)
2003	1,120,000 ($1,000,000 indexed for inflation)
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000
2010	(GST tax repealed under EGTRRA-2001)
2011	1,120,000, plus post-2003 inflation adjustments

It may be desirable to divide one trust into two separate trusts, one of which has an inclusion ratio of zero (a "zero" trust) and one of which has an inclusion ratio of one (a "one" trust). See §12.74B. The amount of GST exemption allocated during the decedent's lifetime can significantly affect allocation at death.

Changes to the GST made by EGTRRA-2001 reflect a recognition that many taxpayers had failed to properly allocate the exemption, divide trusts, or both. Prior to EGTRRA-2001, the ability to divide a single trust into a zero trust and a one trust was extremely difficult or impossible unless complicated regulations were complied with. See Treas Reg §26.2654-1(b). The changes also reduce the need for division because in most cases there is no excess GST exemption that must be allocated to other property after the maximum amount of property has been exempted from estate and gift tax.

Effective immediately on the passage of EGTRRA-2001, IRC §2642(g)(1) requires the issuance of regulations setting forth the circumstances and procedures under which extensions of time will be granted to make GST exemption allocations. In addition, IRC §2642(g)(2) provides that an allocation of GST exemption that demonstrates an intent to have the lowest possible inclusion ratio with respect to that transfer will be deemed to be an allocation of as much of the transferor's unused GST exemption as will produce the lowest possible inclusion ratio.

NOTE: In 2008, the IRS issued proposed regulations under IRC §2642(g)(1). The Preamble provides that the proposed regulations, when finalized, will replace Treas Reg §301.9100-3 with respect to the granting of relief under IRC §2642(g)(1). See REG-147775-06, 2008-19 Int Rev Bull 916. The IRS provided temporary guidance in Notice 2001-50, 2001-2 Cum Bull 189, for securing an extension of time to allocate the GST exemption by submitting a request for private letter ruling. In Rev Proc 2004-46, 2004-2 Cum Bull 142, the IRS modified Notice 2001-50 to provide a simplified method for obtaining an extension of time to allocate the GST exemption that requires neither a request for private letter ruling nor the user fee required when making such a request.

EGTRRA-2001 made substantial changes in the automatic allocation of GST exemption, in an attempt to reduce the number of improper or unmade allocations. Effective for transfers made after December 31, 2000, if an individual makes a lifetime indirect skip, any unused portion of the individual's GST exemption is allocated to the property to the extent necessary to make the inclusion ratio for such property equal to zero. IRC §2632(c)(1)-(2). This is important

because it affects the GST exemption available at death.

An indirect skip is a transfer of property, other than a direct skip, to a GST trust, which is subject to the gift tax. IRC §2632(c)(3)(A). A GST trust is a trust that could have a GST transfer with respect to the transferor; however, there are six separate exceptions to this definition that must be carefully reviewed if the transferor does not elect to either opt into or opt out of the deemed allocations rules. IRC §2632(c)(3)(B). A transferor may elect to opt into or opt out of the deemed allocation rules applicable to indirect skips, if the election is made on a timely filed gift tax return for the calendar year in which the transfer was made. IRC §2632(c)(5). The election procedures are prescribed in Treas Reg §26.2632-1(b)(2).

EGTRRA-2001 permits late allocations of GST exemption to be effective retroactive to the date of the transfer under certain circumstances. IRC §2632(d). This may be particularly useful when deaths occur out of order, *e.g.,* when a child predeceases a parent.

Allocation of GST exemption must be made on or before the filing due date of the estate tax return (with any extensions). IRC §2632(a)(1). Once made, the allocation is irrevocable. IRC §2632(b).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.74A 2. Computing Generation-Skipping Transfer Tax

§12.74A 2. Computing Generation-Skipping Transfer Tax

The GST tax is computed by multiplying the taxable amount by the applicable rate. The applicable rate is determined by multiplying the highest tax rate applicable to federal estate taxes in the year of the transfer by the inclusion ratio. IRC §2641.

Under EGTRRA-2001, the maximum estate tax rates are as follows:

Year	*Maximum Marginal Rate %*
2001	55
2002	50
2003	49
2004	48
2005	47
2006	46
2007	45
2008	45
2009	45
2010	0
2011	55

The GST tax is levied in addition to any estate or gift tax paid.

The inclusion ratio is the mechanism by which the transferor allocates his or her GST exemption. See IRC §2642. It is calculated by the following formula:

$$1 - \frac{\text{the amount of GST exemption allocated to the GST}}{\text{the value of the particular GST (less estate taxes paid and charitable deductions allowed)}} = \text{inclusion ratio}$$

In other words, the *inclusion ratio* is defined in IRC §2642(a)(1) as 1 minus the applicable fraction. The *applicable fraction* is defined in IRC §2642(a)(2) as a fraction, the numerator of which is the amount of GST exemption being allocated to the transfer and the denominator of which is the value of the property being transferred, after certain adjustments for charitable deductions and taxes chargeable to the transferred property.

As long as the inclusion ratio is zero, the property transferred is exempt from the GST tax. If the transfer is made to a trust that skips generations, the inclusion ratio for that trust will remain zero, even if the property transferred to that trust increases in value after the transfer. However, as property is added to the trust to which some of the transferor's GST exemption was previously allocated, the inclusion ratio for that trust must be re-determined. IRC §2642(d). In the event of any such addition, the numerator of the *applicable fraction* will be the sum of the fair market value of the assets held in the trust, determined immediately before the addition, plus any additional unused GST exemption allocated to that transfer; the denominator will be the sum of the fair market value of the property transferred, after certain adjustments for charitable deductions and taxes chargeable to the transferred property, plus the fair market value of the assets held in the trust determined immediately prior to the addition. To the extent that the trust does not meet the definition of a GST trust to which an automatic allocation of the GST exemption will be made under IRC

§2632(c) and the transferor does not allocate additional GST exemption to that transfer, or the transferor does not have remaining GST exemption to allocate to that transfer in an amount sufficient to create a "zero" trust, a GST tax will become payable on a portion of the trust from that date forward. See IRC §2642(d).

EXAMPLE: As an illustration of these rules, assume T transferred assets with a reported fair market value of $1,000,000 into a trust in 2004 and allocated $1,000,000 in GST exemption to that transfer. The *applicable fraction* for this transfer is determined by dividing the $1,000,000 GST exemption allocated by the transferor to this transfer by the fair market value of assets transferred to the trust ($1,000,000), *i.e.,* 1. The *inclusion ratio* is determined by subtracting the applicable fraction (1) from the number 1, *i.e.,* zero. The *applicable rate* of GST tax is determined by multiplying the top marginal estate tax rate by the inclusion ratio (0), *i.e.,* zero, so all taxable distributions from and taxable terminations of that trust will be fully exempt from GST tax. However, if it is ultimately determined that the fair market value of assets T transferred was $2,000,000 in 2004, the *applicable fraction* is determined by dividing the $1,000,000 GST exemption allocated to this transfer by the fair market value of assets transferred to the trust ($2,000,000), *i.e.,* ½; the *inclusion ratio* is determined by subtracting the applicable fraction (½) from 1; and the *applicable rate* of GST tax is determined by multiplying the top marginal estate tax rate by the inclusion ratio. The actual GST tax rate will depend on the top marginal estate tax rate.

In the alternative, if the fair market value of the property initially transferred to the trust in Example 1 was $1,000,000 but T transferred an additional $500,000 to the trust in 2005 when the fair market value of assets held in the trust before the addition was $1,500,000, and allocated no additional GST exemption, a new applicable fraction would be determined as follows:

- The numerator equals the sum of the fair market value of the assets held in the trust, determined immediately prior to the addition ($1,500,000), plus any additional unused GST exemption allocated to that transfer ($0), *i.e.,* $1,500,000.
- The denominator equals the sum of the fair market value of the property transferred ($500,000), plus the fair market value of the assets held in the trust determined immediately prior to the addition ($1,500,000), *i.e.,* $2,000,000.

The new applicable fraction would be 1,500,000/2,000,000. The new inclusion ratio for the trust would be 1 minus the new applicable fraction, *i.e.,* 0.25, and the rate of GST tax that would now apply to all taxable distributions from, or terminations of, the trust would be the maximum estate tax rate for the year of the distribution or termination, multiplied by 0.25.

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§12.74B 3. Dividing Trust Into Exempt and Nonexempt Trusts

A trust with an inclusion ratio between zero and 1 may be divided into two trusts in a "qualified severance" so that one trust will have an inclusion ratio of 1 and the other will have an inclusion ratio of zero. IRC §2642(a)(3). A qualified severance is only available if permitted either in the trust instrument or under applicable local law. IRC §2642(a)(3)(B)(i); Treas Reg §26.2642-6(d)(7) (division into more than two trusts).

NOTE: There is currently no provision in the California Probate Code specifically authorizing a "qualified severance." As a result, the trustee may not take advantage of IRC §2642(a)(3) unless the trust instrument permits the division of a single trust into two or more subtrusts. However, if the trust instrument does not permit division of the trust, the trustee may petition the court to divide the trust under Prob C §15412. See §14.54.

If a qualified severance is permitted under the trust instrument or local law, the trust must be divided on a fractional basis and the terms of the new trusts, in the aggregate, must provide for the same succession of the beneficiaries' interests as provided in the original trust. IRC §2642(a)(3)(B); Treas Reg §26.2642-6(d)(5).

EXAMPLE: If the decedent died in 2006, and a trust created for the benefit of a decedent's grandchildren under the decedent's will receives $2,000,000, but the decedent only has $1,000,000 of GST exemption available because $1,000,000 was allocated to lifetime gifts, only $1,000,000 of GST exemption can be allocated to the testamentary trust. In the absence of a qualified severance, the testamentary trust will have an applicable fraction of ½ and an inclusion ratio of 0.50, and the applicable rate of GST tax on all taxable distributions from, and terminations of, that testamentary trust will be the maximum estate tax rate for the year of the distribution or termination multiplied by 0.50. If, however, the decedent's will permits the trustee of the testamentary trust to divide that one testamentary trust into two subtrusts, the trustee may complete a qualified severance of the one testamentary trust into two subtrusts. The balance of the decedent's GST exemption will be allocated to one of the trusts, which will hold $1,000,000 and, as a result, be fully exempt from GST tax. The other trust will hold the remaining $1,000,000 and, as a result, will be fully subject to GST tax. The separate subtrust to which the GST exemption is allocated would have an applicable fraction of 1, an inclusion ratio of zero and the applicable rate of GST tax would be zero (the "zero" trust) and the other subtrust would have an applicable fraction of zero, an inclusion ratio of 1, and the applicable rate of GST tax would be the maximum estate tax rate (the "one" trust). To the extent distributions are made to the transferor's children (nonskip persons) from the "one" trust, until exhausted, and the "zero" trust is reserved for the transferor's grandchildren (skip persons), the GST tax that might otherwise have applied to the single trust can be dramatically reduced, if not eliminated.

For multiple transfers to a trust, special valuation rules, and other miscellaneous rules, see IRC §§2642(b)-(f), 2653-2654. For a discussion of calculating and allocating the GST tax in connection with the QTIP election and GST reverse QTIP election, see California Will Drafting §§15.34-15.93 (3d ed Cal CEB 1992).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.75 G. Other Exemptions From Generation-Skipping Transfer Tax

§12.75 G. Other Exemptions From Generation-Skipping Transfer Tax

In addition to the GST exemption (see §§12.74-12.74B), the GST tax is subject to the following exemptions:

- Any transfer made during the transferor's lifetime that is not treated as a taxable gift under IRC §2503(e) (relating to transfers for certain educational or medical expenses) is exempt. IRC §2611(b)(1).
- Certain transfers that qualify for the annual exclusion from gift tax under IRC §2503(b) will be exempt. IRC §2642(c).
- If the property transferred was already subject to a prior GST tax, the previous transferee was assigned to the same (or a lower) generation as the present transferee, and the transfers do not have the effect of avoiding the GST tax, then the present transfer will be exempt. IRC §2611(b)(2).

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§12.76 H. Identification of Generation-Skipping Transfers

The prompt identification of GSTs is necessary to avoid potential tax problems. Any revocable trust created on or after the effective date of the GST tax (see §12.78) should be reviewed to determine whether the plan of distribution falls within the statutory definition of a GST. In reviewing a trust to determine whether distribution would be a GST, the trustee's attorney and the trustee should ask the following questions; if the answer to either of them is "yes," then the trust will not be subject to the tax:

- Is the transferee a charitable organization under IRC §511(a)(2), a charitable trust under IRC §511(b)(2), or a government entity? See IRC §2651(f)(3).
- Are all of the interests in the trust vested in nonskip persons?

NOTE: If a nonskip person holds a testamentary general power of appointment over his or her share of the trust, and the trust does not permit distributions to be made to skip persons during the lifetime of nonskip persons, the GST tax will never apply.

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§12.77 I. Tracking Transfers and Filing Returns

The attorney should review all irrevocable trusts created by the client that could possibly be subject to GST tax to determine:

- What, if any, of the trustor's (client's) GST exemption has already been allocated to each such trust (review all gift tax returns IRS Form 709 which have been filed by the client starting in 1987);
- Whether some or all of the trustor's (client's) unallocated GST exemption will be allocated to such trusts under the revised allocation rules enacted as part of EGTRRA-2001;
- Whether the trustor (client) should elect out of the automatic allocation rules; and
- Whether and the extent to which the trustor (client) should attempt to secure retroactive allocations of his or her GST exemption.

The event that triggers a GST will also trigger the beginning of the period during which the returns for the transaction must be prepared and filed by the trustee. IRC §2661; Rev & T C §16720.

Lifetime direct skips must be reported on the transferor's gift tax return, IRS Form 709. Direct skips at death must be reported on Schedule R or Schedule R-1, which will be attached to the estate tax return, IRS Form 706, being filed for the deceased transferor. Taxable distributions and taxable terminations must be reported by trustees and distributees on IRS Forms 706-GS(D-1), 706-GS(D), and 706-GS(T). Tax returns are due on April 15 of the year following the year in which the GST occurs, although trustees and distributees can apply for an automatic 6-month extension of time to file returns. IRC §2662; Treas Reg §26.6081-1. However, the trustee may obtain only a 5-month extension to file the trust income tax return. Temp Treas Reg §1.6081-6T. Because these returns must be consistent, the trustee should plan on filing the GST tax return within the 5-month period. The shorter period is intended to result in distributees receiving forms documenting their respective shares of distributable net income (DNI) before the distributees must file their own tax returns. See chap 11.

Corporate trustees normally identify and track all generation-skipping trusts that they administer. Nevertheless, to avoid future errors, the attorney for a corporate trustee may wish to provide an opinion letter on whether the trust is subject to the GST tax and, if so, what the applicable rate of GST tax will be with respect to each such trust. The GST tax is complex, and many corporate trustees do not necessarily have sufficient expertise to identify all generation-skipping situations.

When an individual trustee is administering the trust, the attorney should provide clear and simple explanations of what actions will trigger the GST tax and advise the trustee in connection with the proper reporting of each transaction and the GST tax due on a timely basis.

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§12.78 J. Effective Dates for Transfers

The GST tax applies to all generation-skipping transfers made after October 22, 1986, the enactment date of the Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, 100 Stat 2085). See TRA 1986 §1433(a). In addition, the GST tax rules apply to all lifetime transfers made after September 25, 1985 (unless the transfer was made under a trust that was irrevocable on September 25, 1985, and the property was not corpus added after that date, or income from such corpus). TRA 1986 §1433(b)(1), (b)(2)(A) (as amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) (Pub L 100-647, §1014(h)(2)(B), 102 Stat 3342).

The exercise, release, or lapse of a general power of appointment under a trust that was irrevocable on September 25, 1985, is treated under the regulations as resulting in a constructive addition to the trust. Treas Reg §26.2601-1(b)(1)(i). The Tax Court has held in a reviewed decision that the regulation is valid in a case involving the exercise of a power. See *Estate of Eleanor R. Gerson* (2006) 127 TC 139, aff'd (6th Cir 2007) 507 F3d 435. See also *E. Norman Peterson Marital Trust v Commissioner* (2d Cir 1996) 78 F3d 795, in which the court held that a surviving spouse made a constructive addition to a trust when she failed to exercise a right to withdraw one-half of the trust estate and instead allowed the property subject to the power to pass to skip persons. However, the Ninth Circuit has expressed doubt as to whether this provision is valid if the affected property is actually removed from the trust as a result of the exercise of the power, although the decision related to events arising before the effective date of the regulation. See *Bachler v U.S.* (9th Cir 2002) 281 F3d 1078. See also *Simpson v U.S.* (8th Cir 1999) 183 F3d 812. Despite these doubts, holders of general powers under exempt trusts may want to consider exercising those powers rather than allowing them to lapse and, to the extent the planner is not inclined to rely on the opinions of the Eighth and Ninth Circuits, to limit any such appointment to skip persons in a way that ensures that the portion passing to skip persons will not exceed the balance of the GST exemption not allocated automatically or otherwise by the power holder during his or her lifetime.

Transfers by will or revocable trust executed before October 22, 1986, are exempt from the GST tax if the decedent died before January 1, 1987. TRA 1986 §1433(b)(2)(B) (as amended by TAMRA §1014(h)(2)(C)). A further exemption applies to certain decedents who were mentally disabled on October 22, 1986, and continued to be so until the time of death. See TRA 1986 §1433(b)(2)(C). Transfers made from a transferor to a particular grandchild before January 1, 1990, aggregating $2 million or less, are not considered direct skips ("Gallo Amendment"). See TRA 1986 §1433(b)(3) (as amended by TAMRA §1014(h)(3)(A)). For further discussion of effective dates, exceptions, and special transition rules, see California Will Drafting, chap 15 (3d ed Cal CEB 1992).

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.79 V. CHECKLIST: ESTATE TAX CONSIDERATIONS IN ESTATE ADMINISTRATION

§12.79 V. CHECKLIST: ESTATE TAX CONSIDERATIONS IN ESTATE ADMINISTRATION

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1. Elections To Deduct Certain Expenses for Estate or Income Tax Purposes

- Administration expenses and casualty losses; see §12.42

Consider:

- Nature of expenses and qualification under IRC §2053
- Whether expenses are incurred in administering both decedent's property and surviving spouse's share of community property
- Estate tax bracket compared with fiduciary income tax bracket
- Last-illness expenses paid within 1 year after date of death

Consider:

- Dates medical expenses paid
- Estate tax bracket compared with fiduciary income tax bracket
- Floor for income tax deduction for medical expenses under IRC §213

2. Estate Asset Valuation Elections

- Alternative valuation date (6 months after date of death or date estate disposes of asset, whichever is earlier) (IRC §2032); see §12.21

Consider:

- Effect on total estate taxes to be paid by estate
- Effect on qualification for payment of federal estate tax in installments under IRC §6166; see §12.27
- Effect on availability of stock redemptions under IRC §303
- Effect on marital deduction
- Special-use valuation of real property used in farming or other trade or business (irrevocable election made by attaching to federal estate tax return notice of election and written agreement of persons who have interests in property) (IRC §2032A); see §§12.22-12.24

Consider:

- Effect on total estate taxes to be paid by estate
- Effect on qualification of estate for installment payment of federal estate tax under IRC §6166; see §12.27
- Qualification for stock redemption under IRC §303
- Protective election; see §12.23
- Valuation exclusion for real property subject to a qualified conservation easement (IRC §2031(c)); see §12.29.
- Irrevocable election made by attaching to federal estate tax return notice of election
- Effect on availability of stock redemptions under IRC §303

Consider:

- Effect on total estate taxes to be paid by estate
- Effect on qualification of estate for installment payment of federal estate tax under IRC §6166; see §12.27

3. Qualified Family-Owned Business Interests Deduction (IRC §2057) for decedents dying on or before December 31, 2003; see §12.25

- Irrevocable election made by attaching to federal estate tax return notice of election and written agreement of persons who have interests in property

Consider:

- Effect on total estate taxes to be paid by estate
- Effect on qualification for installment payment of federal estate tax under IRC §6166; see §12.27
- Effect of potential recapture
- Identity of persons to pay tax and interest if recapture occurs
- Agreement among beneficiaries covering payment of interest and tax if recapture, and possible indemnity
- Protective election; see §12.25

4.a. Qualified Terminable Interest Property (QTIP) Election (IRC §2056); see §12.26

- Election made by entering, in whole or in part as a deduction, the value of the trust or other property on Schedule M of IRS Form 706

Consider:

- Potential appreciation in value of estate
- Surviving spouse's life expectancy
- Availability of cash to pay taxes at first spouse's death
- Projected availability of funds to pay taxes at surviving spouse's death
- Partial election and proper identification on Schedule M

4.b. Qualified Domestic Trust (QDOT) Election (IRC §2056A); see §12.46

- Election made by listing and entering as a deduction the entire value of a trust or trust property on IRS Form 706, Schedule M

Consider:

- Citizenship of surviving spouse; likelihood of attaining U.S. citizenship before filing of IRS Form 706
- Use of prior transfer property (PTP) credit (IRC §§2013, 2056(d)(3)) in lieu of QDOT at decedent's death.
- Need to reform trust; pay particular attention to special requirements with respect to trustees of QDOT
- Ability of noncitizen spouse to create QDOT after decedent's death to permit application of special marital deduction available to noncitizen spouses
- All of the other factors relevant to a QTIP election (see 4.a.)
- Payment of estate tax on distributions of principal to surviving spouse for purposes other than "hardship"

5. Disclaimers (IRC §2518)

- May save estate taxes in surviving spouse's estate by avoiding overqualification for marital deduction
- May be made by beneficiaries other than surviving spouse to allow property to pass directly to surviving spouse, qualifying that property for marital deduction
- May avoid generation-skipping transfers
- May avoid general powers of appointment, preventing adverse estate and income tax consequences
- Written disclaimer must be delivered within 9 months after transfer creating interest in disclaimant is made (or 9 months after disclaimant attains age 21) in order to be effective for federal estate tax purposes
- Written disclaimer must be signed by either disclaimant or disclaimant's legal representative
- Warn disclaimants that "acceptance of benefits" from property to be disclaimed will prevent disclaimer of

property

6. Requirements for Imposition of California Estate Tax; see §12.3
    - Decedent died after June 8, 1982, and before January 1, 2005
    - Decedent dying after December 31, 2010
    - Decedent owned property in California
    - A federal estate tax return is required

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Source: Estate Planning/California Trust Administration/12 Estate Tax Returns/§12.80 VI. PROCEDURAL GUIDE: FILING ESTATE TAX FORMS

§12.80 VI. PROCEDURAL GUIDE: FILING ESTATE TAX FORMS

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1. File Notice Concerning Fiduciary Relationship (IRS Form 56). See §12.7.
2. File either United States Estate Tax Return (IRS Form 706 or Form 706-NA if decedent was not a U.S. citizen or resident) or application for extension of time to file estate tax return (IRS Form 4768) within 9 months from date of death. IRC §6075. Tax is payable on filing. See §§12.9-12.14 for discussion of filing requirements and §§12.57-12.60 for discussion of payment of tax.
3. When IRS Form 706 is filed, consider sending a letter to District Director requesting discharge from personal liability for the tax, under IRC §2204. See §12.63.
4. For deaths occurring before January 1, 2005, and after December 31, 2010, file California Estate Tax Return (Form ET-1) within 9 months from the date of death. Tax is payable on the date of filing. Rev & T C §13501; see §§12.64-12.69.
5. If an amended federal estate tax return is filed, immediately file an amended California estate tax return, if required, with a copy of the amended federal return and payment of any additional California tax plus interest. Rev & T C §13503.
6. For deaths occurring before January 1, 2005, and after December 31, 2010, give written notice of final determination of the federal estate tax to Controller within 60 days of the determination, accompanied by the payment of any additional California estate tax plus interest. Rev & T C §13504.
7. On discharge of the representative's personal liability, send notice of discharge and a certified copy of the order to District Director.

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13

Administering Single-Person Trust After Settlor's Death

David B. Gaw

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§13.1 I. SYSTEMATIC APPROACH TO ADMINISTRATION

This chapter presents a systematic approach to administering a single-person revocable trust after the death of the settlor, including a step-by-step procedural checklist. See §13.2.

At the outset, the attorney should understand that there is a common misconception that professional services are unnecessary in the administration of revocable trusts after death. In fact, even though most successor trustees do not know it, probate and trust administration require the same three administrative functions:

- Making an inventory of assets;
- Paying debts and taxes; and
- Distributing the remaining assets to the designated beneficiaries, including any ongoing successor trusts.

In probate, court supervision imposes structure and formality on this process. With a revocable trust, the lack of probate court supervision and the ensuing absence of formal procedures can make trust administration more complex than probate. It is therefore incumbent on the professional team, primarily the lawyer and CPA, to impose formality where none exists. See discussion in chap 17.

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§13.2 II. COMPREHENSIVE PROCEDURAL CHECKLIST

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A. Step One: Prepare for First Meeting

- 1. First telephone call
- 2. Review the estate planning documents
- a. Review the trust instrument
- (1) General dispositive provisions
- (2) Powers of appointment
- (3) Prorata or nonprorata distribution
- (4) Disclaimers
- (5) Estate tax clause
- (6) Administrative trust clause
- (7) Allocation of principal and income
- (8) Prudent investor clause
- (9) Reporting and accounting clause
- (10) Trustee provisions
- (11) S corporation issues
- (12) Generation-skipping transfer (GST) tax issues
- (13) Power to divide trust
- (14) Payment of interest
- (15) Gift provisions
- (16) Disqualified persons
- (17) Ambiguities and drafting errors
- (18) Asset schedule
- b. Pourover will
- c. Review other documents
- 3. Prepare summary of estate planning documents

B. Step Two: First Meeting With Client (Successor Trustee)

- 1. Identify the client and be aware of ethical issues
- 2. Complete new client information sheet
- 3. Educate client about trust administration
- 4. Summarize the trust and distribution provisions
- 5. Collect asset information
- a. Review title to assets
- (1) Assets in the trust

- (2) Assets outside trust subject to distribution by will
- (3) Assets outside trust not subject to distribution by will
- b. Determine whether legal action is required to collect assets into trust
- c. Estimate value of assets
- d. Discuss need for appraisals
- e. Identify need for investment advice and make referral to broker
- f. Identify dividend reinvestment accounts
- g. Identify out-of-state real property
- h. Identify depreciating or wasting assets
- i. Identify assets subject to special regulatory or contractual controls
- j. Identify safe deposit boxes and arrange for inventory
- k. Discuss insurance coverage
- l. Identify assets subject to options, escrows, or foreclosures
- m. Identify hazardous waste problems
- n. Have client sign authorization forms
- 6. Collect liability information
- a. Determine nature and amount of outstanding liabilities
- b. Identify potential creditors and outstanding lawsuits
- c. Discuss liability of trust for decedent's debts
- d. Discuss optional creditor's claim procedure
- e. Consider 1-year statute of limitations
- 7. Collect beneficiary information
- 8. Review document list
- 9. Discuss fiduciary duties
- a. Source of trustee powers
- b. Standard of trust management
- c. Fiduciary relationship
- d. Protect, preserve, and make trust property productive
- e. Anticommingling rule
- f. Duty to defend the trust
- g. Nondelegation of trustee powers
- 10. Send Prob C §16061.7 notice to beneficiaries and heirs
- 11. Reporting and accounting requirement
- a. Duty to keep beneficiaries informed
- b. Mandatory accounting requirements for trusts established after July 1, 1987
- c. Contents of account
- d. Accounting on request of any beneficiary
- e. Waivers
- f. Recommend voluntary accounting even when not required
- g. Consider obtaining court approval of accounting

- 12. Recordkeeping
- 13. Principal and income law
- 14. Discuss trust checking account and trust transactions
- a. Advise client to open trust checking account
- b. Determine whether administrative expenses already paid and arrange for reimbursement
- c. Present client with list of administrative expenses
- 15. Discuss estate tax issues
- a. Consider need to file IRS Form 706 and state estate tax returns or extensions
- b. Consider filing Form 706 even when not required
- c. Consider need for and timing of extension to file and/or pay tax
- d. Discuss alternate valuation
- e. Discuss special tax elections that might be available
- f. Identify property for possible prior property transfer credit
- g. Review prior gifts
- h. Identify assets includable although not otherwise inventoried
- i. Determine need for state estate tax returns in states other than state of domicile
- j. Consider GST issues
- k. Consider disclaimer planning
- (1) To reduce or eliminate marital gift to fully use unified credit
- (2) To create a marital deduction
- (3) To perfect or increase charitable deduction gift
- (4) To avoid general powers of appointment
- (5) To skip a generation
- (6) To qualify for stock redemption under IRC §303
- (7) To eliminate nonqualified heirs to qualify for IRC §2032A
- (8) To avoid multiple administrations and unnecessary estate taxes
- (9) To terminate a trust
- (10) To avoid income taxes
- (11) To accelerate estate tax to qualify for PTP credit
- l. Consider need to coordinate with insurance trust for payment of estate taxes
- 16. Discuss income tax issues
- a. Allocate responsibility for decedent's personal returns and fiduciary returns
- b. Determine what returns need to be filed
- c. Explain basis step-up
- d. Determine whether to use administrative trust
- (1) Terminated trust approach
- (2) Administrative trust approach
- (3) Factors in deciding
- e. Is the trust simple or complex?
- f. Accumulation of income permitted

- g. Trusts must report on calendar-year basis
- h. Discuss income tax brackets for trusts
- i. Consider timing of distributions (65-day rule)
- j. Discuss need to issue IRS Form 1099s
- k. Personal exemption
- l. Quarterly estimates for trust
- m. S corporation
- n. Passive loss deduction
- o. Income tax consequences of funding bequests
- (1) Nonprorata distributions from trust
- (2) Types of bequests and tax consequences
- p. Discuss trust income during administration period
- q. Have client sign IRS Form SS-4 to obtain TIN for administrative trust
- 17. Discuss real property tax issues
- a. Determine whether "change of ownership" occurs for property tax purposes
- b. Determine whether parent-child exclusion available
- (1) Calculate and allocate the exclusion
- (2) Application to ongoing trusts
- (3) Determine time for filing parent-child exclusion application
- 18. Discuss trustee compensation and time records
- 19. Preliminary liquidity analysis.
- 20. Discuss fees, costs, retainer, and fee agreement

C. Step Three: Actions Following First Meeting

- 1. New case set up
- a. Set up new trust administration file
- b. Prepare and mail fee agreement
- c. Prepare joint representation agreement (applies only if there are co-trustees)
- d. Apply for TIN if using administrative trust
- 2. Calendar critical dates
- a. Lodge pourover will with county clerk (30 days from death)
- b. Notification to beneficiaries (60 days from death)
- c. Disclaimer deadline (9 months from death)
- d. Form 706 and state returns', if any (9 months from death)
- e. Date of Form 706 extension, if any
- f. Alternate valuation date (6 months from death)
- g. IRS Form 709 (gift tax returns) (4/15)
- h. Decedent's final personal returns (4/15)
- i. Fiduciary income tax returns (4/15 if calendar year; 15th day of 4th month after fiscal year end if fiscal year)
- j. Preliminary Change of Ownership Statement (150 days from death)

- k. Property tax installments (12/10 and 4/10)
- l. Survival requirements under instrument
- m. 65-day election (IRC §663(b))
- n. Partnership basis election (IRC §754) (date partnership return due)
- o. Federal/state payroll tax reporting
- p. S corporation election (within 2 months and 16 days of transfer)
- q. Medi-Cal notice (90 days from death)
- r. Prob C §13100 affidavit (40 days from death)
- s. Option, escrow, or buy-sell dates
- t. First trust accounting due (1 year from death)
- u. Statute(s) of limitation on decedent's cause(s) of action
- v. Creditor claim period (if opt in) (4 months from date of first publication)
- w. Statute of limitations on claims against decedent (1 year from death)
- x. Last day to contest trust (120 days from date Prob C §16061.7 notice is received, or up to 60 days later if trust copy not sent originally)
- y. Deadline for noncitizen spouse to transfer or irrevocably assign assets to QDOT (due date for filing Form 706, including extensions)
- z. Deadline for noncitizen spouse to become citizen, if not creating QDOT (due date for filing Form 706, including extensions)
- aa. Beneficiaries take decedent's minimum required distribution if decedent has passed RBD (12/31 in the year of decedent's death)
- bb. Determine beneficiaries of retirement plan or IRA (9/30 in year after year of decedent's death)
- cc. Deadline for dividing retirement plan or IRA into separate accounts (12/31 in the year after year of decedent's death)
- dd. If trust is named as beneficiary of retirement plan or IRA, send list of trust beneficiaries and a copy of the actual trust instrument to plan administrator or fiduciary (10/31 in year after year of decedent's death)
- 3. Lodge pourover will with county clerk and obtain certified copy
- 4. Prepare and send Medi-Cal notice
- 5. Prepare certification of trust and affidavit of death
- 6. Prepare and file PCOR form
- 7. Collect asset and liability information
- a. Prepare preliminary inventory and mail to client with sample asset list
- b. Prepare and send letters to financial institutions
- c. Prepare and send letters to insurance companies
- d. Order deeds from title company for all real property
- e. Order appraisals for all parcels of real property
- f. Order appraisals for tangible personal property
- g. Order appraisals for intangible personal property
- h. Order appraisals for business interests
- i. Prepare and send letters re retirement benefits
- j. Enter data into asset allocation spreadsheet and fiduciary accounting program
- 8. Prepare forms for creditor claim procedure

- 9. Record certification of trust in each county where real property located
- 10. Prepare and send IRS Form 4506 requesting copies of gift tax returns
- 11. Prepare and send information letter to beneficiaries
- 12. Prepare and send trust administration memo
- 13. Prepare letter of instructions to brokers
- 14. Deliver stock certificates to broker
- 15. Prepare CPA designation form
- 16. Communicate with out-of-state counsel for ancillary proceedings
- 17. Prepare and file parent-child exclusion application
- 18. Determine need to start court proceedings and prepare petitions
- 19. Prepare documents to collect nontrust assets
- 20. Corporate review and housekeeping for closely held corporation
- 21. Communicate with CPA
- 22. Cancel decedent's credit cards and contact national credit reporting agencies to close decedent's credit profile

D. Step Four: Second Meeting With Client (and CPA)

- 1. Verify trust checking account established
- 2. Review client's recordkeeping
- 3. Discuss progress on collection and appraisal of assets
- 4. Discuss possible sales of assets
- a. Determine need for liquidity
- b. Consider preference for cash versus in-kind distributions
- c. Review trustee's authority to sell
- d. Consider tax consequences of sale
- e. Discuss method of sale
- f. Watch for conflict of interest
- g. Consider obtaining court approval
- 5. Consider preliminary distributions
- a. Consider income tax effects
- b. Beware of disproportionate preliminary distributions
- 6. Prepare and send letter to CPA confirming allocation of responsibilities

E. Step Five: Final Distribution

- 1. Finalize asset collection
- 2. Finalize fiduciary accounting schedules
- 3. Determine administration expenses incurred
- 4. Decide whether to take administration expenses on Form 706 or IRS Form 1041
- 5. Finalize and file Form 706/state estate tax returns
- 6. Draft trustee's final account and report
- 7. Determine whether court approval of accounting appropriate
- 8. Consider timing of distribution

- 9. Consider income tax effects
- 10. Analyze available assets
- 11. Determine whether distribution will be pro rata or non-pro-rata
- 12. Determine whether any distributions carry earned income or interest
- 13. Determine amount of reserve
- 14. Determine amount of trustee's fee
- 15. Select allocation (distribution) date
- 16. Update values of assets and amounts of liabilities as of distribution date
- 17. Prepare asset allocation spreadsheet
- 18. Prepare written schedule of assets for ongoing trusts
- 19. Obtain TINs for ongoing trusts
- 20. Prepare certificates of trust for ongoing trusts
- 21. Prepare diagram of distribution
- 22. Send drafts of spreadsheet, asset schedules, and diagram to client and CPA
- 23. Consider review of distribution plan by beneficiaries
- 24. Consider court approval of distribution plan
- 25. Obtain trustee's and CPA's approval of distribution plan
- 26. Prepare transfer documents for funding distributions
    - a. Written instructions to trustee re title to bank accounts
    - b. Deeds, etc.
    - c. Assumption of mortgages
    - d. Assignments of lease
    - e. Assignments of notes and deeds of trust
    - f. Prepare and file UCC-2 statements
    - g. Cancel old and issue new stock certificates for closely held corporations
    - h. Assignments of partnership interests
    - i. Assignments of unsecured promissory note
    - j. Letters to makers on notes advising of assignment
    - k. Assignments of assets of sole proprietorship
    - l. Assignments of personal property
    - m. Forms to complete transfer of mobilehomes
    - n. Stock powers, affidavit of domicile, and letter of instructions for stock transfers
    - o. Letters to transfer agents or deliver certificates to broker for transfer
    - p. Letters of instructions to broker to transfer securities accounts
    - q. Letters of instructions to mutual fund companies for transfer of accounts
    - r. Transfer forms for Treasury notes and bonds
    - s. Letter and forms for transferring United States Savings Bonds
    - t. Complete transfers of vehicles (cars, boats, airplanes)
    - u. Miscellaneous assignments for other assets

- 27. Prepare waivers of accounting if no formal accounting
- 28. Prepare beneficiary receipts
- 29. Mail accounting, distribution checks/documents, and receipts by certified mail
- 30. Prepare letter of instructions to client re administration of ongoing trusts
- 31. Prepare letter to CPA re ongoing trusts and allocation of responsibility
- 32. Send closing packet and termination-of-engagement letter to client
- 33. Send client-satisfaction survey form to trustee

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III. STEP ONE: PREPARATION FOR FIRST MEETING WITH CLIENT

§13.3 A. Initial Contact and Conflict Check

The first contact with the prospective client is usually a telephone call advising the attorney that the client's relative has died. Be careful about disclosing information during this initial phone conversation, particularly if the person making the phone call is not the actual client. See §13.21. At this stage, the practitioner should avoid explaining much about the trust administration process; hold that discussion for the first meeting.

Well-intentioned trustees sometimes engage in postmortem self-help by transferring joint bank and brokerage accounts and filing life insurance and retirement benefits claims without consulting an attorney, thinking "Why should we pay the attorney to do this easy stuff?" Moreover, the prospective client probably believes the living trust myth (see §13.23): Once a living trust has been created, its administration is simple and free of expenses. In the author's experience, the practitioner cannot try to refute this argument during the first telephone call. An appropriate reply is to urge the caller to make an appointment to talk about it. Trying to explain too much at this stage risks alienating the client.

During the first phone call, the practitioner should obtain initial information for a client information and tracking sheet. See §13.82. Advise the prospective client to mail or deliver the estate planning documents if the practitioner does not already have copies. After the phone call, mail or fax a letter to the client to confirm the appointment (see §13.83), with a list of information and documents needed (see §13.84).

The practitioner should conduct a conflict check for the potential client as part of this initial process or do it later at the first meeting. See §13.85.

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§13.4 B. Review Estate Planning Documents and Prepare Summaries

A thorough review of the estate planning documents before the meeting will ensure the client's confidence in the practitioner's abilities and understanding. For an example based on a hypothetical single-person trust, see §13.81.

In addition to analyzing the trust instrument, review all other estate planning documents, including the pourover will (see §13.19) and irrevocable inter vivos trusts that were established by the deceased settlor. Frequently, the irrevocable trust contains life insurance, and there may well be either a sale or loan between the revocable and irrevocable trust in order to transfer the insurance proceeds to the revocable trust to pay estate taxes. Also review the irrevocable trust for drafting errors that may cause assets to be includable in the decedent's estate. Verify funding of the irrevocable trust.

Review other relevant documents as well, such as agreements affecting the character of trust property, *e.g.*, community property agreements, prenuptial or postnuptial agreements, and buy-sell or option agreements.

As part of the review process, summarize the terms of the trust, the pourover will, and other estate planning documents for later reference. See §13.86. The summary can be reproduced on colored paper to make it stand out in the file.

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§13.4A 1. Trust Instrument

In reviewing the trust instrument, determine the validity of any trust amendments that may have been made by the settlor's agent under a power of attorney. Amendments made by an agent must be expressly authorized by the trust instrument. Prob C §15401(c). Amendments made by an agent also must be expressly authorized by the power of attorney. Prob C §4264(a). Furthermore, amendments made by an agent may not change trust beneficiaries unless expressly authorized by the power of attorney. Prob C §4264(f). See *Schubert v Reynolds* (2002) 95 CA4th 100, 115 CR2d 285, discussed in §16.29. For further discussion of estate planning powers that allow agents to amend trusts, see Drafting California Revocable Trusts §§14.12, 20.8 (4th ed Cal CEB 2003). See also California Powers of Attorney and Health Care Directives, chap 6 (Cal CEB 2008).

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§13.5 a. General Dispositive Provisions

Review the trust instrument for general dispositive provisions to determine whether there are any specific gifts of assets or assets specifically devised that are included in the trust estate, whether distributions are to be made outright to the beneficiaries or to continuing trusts for their benefit, and, if there are continuing trusts, whether they are "separate share" trusts or "family pot" trusts.

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§13.6 b. Powers of Appointment

If the trust contains continuing trusts for beneficiaries, determine whether there are any powers of appointment and, if so, whether the powers are general or special. For example, determine whether the trustee has power to confer a general power of appointment and discuss the issue with the trustee.

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§13.7 c. Prorata or Nonprorata Distribution

Determine whether the trust instrument grants the trustee the power to distribute assets on a nonprorata basis or prohibits such distribution. If the trust instrument is silent, or if the power is specified in a written agreement, the trustee under California law may distribute assets either pro rata or non-pro-rata. Prob C §16246. In the absence of a trust provision or statute authorizing nonprorata distribution, the IRS could take the position that the distribution is a taxable exchange between beneficiaries. See IRS Letter Ruling 9422052, distinguishing Rev Rul 69-486, 1969-2 Cum Bull 159. See also IRS Letter Ruling 8119040. Although Prob C §16246 appears to resolve this issue for tax purposes, the trustee must also take non-tax factors into account in deciding whether a nonprorata distribution can be made. In particular, the trustee has the duty to deal impartially with beneficiaries, a duty to avoid any conflict of interest, and a duty to use discretionary powers reasonably. Prob C §§16003, 16004, 16080, 16081. See chap 2.

When a beneficiary requests a prorata distribution, the trustee's fiduciary duties likely require compliance with that request. The trustee is especially vulnerable to a claim for breach of fiduciary duty in this circumstance when the trustee is also a beneficiary of the trust, because a nonprorata distribution of a particularly desirable asset to the trustee in his or her individual capacity may benefit the trustee to the detriment of other beneficiaries. For a discussion of the ethical obligations of an attorney representing a client in the dual capacities of trustee and beneficiary, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel 52 (State Bar of California 2008 ed). See also §1.10. Notwithstanding that Prob C §16246 appears to resolve the tax concerns associated with nonprorata distributions, it does not abrogate the trustee's fiduciary duties.

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§13.8 d. Disclaimers

Consider whether the trust presents any disclaimer planning opportunities (*e.g.,* if there are any wealthy or elderly beneficiaries). Consider also the alternative distributions if disclaimers are made and the duty, if any, of the trustee's attorney to advise beneficiaries concerning disclaimers. For a discussion of disclaimer planning, see §13.39.

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§13.9 e. Estate Tax Clause

Examine the trust provisions for payment of estate taxes. If the trust instrument and will are silent on how estate taxes are to be paid, the default rule under California and federal law is equitable proration. Prob C §20110. Equitable proration applies to the entire gross estate, not just property contained in the trust. See Prob C §§20111-20117. In some cases, the probate court can order equitable adjustments in distribution rights for purposes of taking into account the income tax consequences of trustee administrative actions that reduce estate taxes, but only when the income tax consequences can be ascertained with reasonable certainty. See *Klein v Hughes* (2005) 133 CA4th 121, 34 CR3d 613; *Estate of Bixby* (1956) 140 CA2d 326, 295 P2d 58.

PRACTICE TIP: If a beneficiary is receiving only assets that are passing outside of the trust, the trustee should contact the beneficiary at the beginning of the trust administration and advise of the necessity of paying his or her equitable share of estate taxes when the amount is later determined.

For a sample petition for determination of proration of estate tax, see §13.86A.

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§13.10 f. Administrative Trust Clause

Does the trust instrument mandate the use of an administrative trust? Does the instrument provide for accumulation of income or payment of income during the period of administration? In the author's experience, most trust instruments do not anticipate a postmortem administration period and therefore are silent on these issues. For a discussion of the advantages of establishing an administrative trust, see §§13.44, 14.2-14.6.

Determine whether the net income from an asset in the trust (*e.g.,* a rental property) must be distributed to the beneficiary who receives the asset or whether the income may be used for administration expenses. See Prob C §§16340-16341, 12002-12006.

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§13.11 g. Allocation Between Principal and Income

Review the trust instrument for provisions directing the trustee concerning allocation of receipts and disbursements between principal and income. If the trust does not provide any direction or give the trustee a discretionary power of administration, then allocation must be made in accordance with the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). Prob C §16335(a)(3).

NOTE: To accommodate the UPAIA and the Uniform Prudent Investor Act (Prob C §§16045-16054), the IRS has revised the definition of "income" for federal tax purposes. See Treas Reg §1.643(b)-1, discussed in §§8.3A-8.3F.

For a discussion of allocation between principal and income, see chap 8. For discussion of income tax issues, see chap 11.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.11A h. Prudent Investor Clause

§13.11A h. Prudent Investor Clause

Determine whether the instrument modifies the rules of the Uniform Prudent Investor Act (Prob C §§16045-16054). The basic principles of the Act include the following:

- Portfolio rather than individual investments;
- Balance between risk and return on investments;
- No categoric restrictions on types of investments;
- Duty to diversify investments; and
- Trustee's power to delegate investment and management functions.

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§13.12 i. Reporting and Accounting Clause

Does the trust instrument require accounting to beneficiaries? Does it waive any accounting requirement? Many drafters ignore this issue. If the instrument is silent, the trustee must account at least annually and at the termination of the trust to all beneficiaries entitled or authorized to receive current distributions of income or principal. Prob C §16062.

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§13.13 j. Trustee Provisions

Whom does the trust name as successor trustee to the decedent? Is the same person named as executor in the pourover will? Is there a compensation provision? What are the trustee's powers?

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§13.14 k. S Corporation Issues

If the trust estate includes S corporation stock, make certain that any continuing trusts meet the requirements of a qualified Subchapter S trust (QSST). See IRC §1361(d)(3). If the trusts do not meet these requirements, court reformation proceedings may be required. Also look for savings provisions in the trust instrument, and consider whether they are effective to preserve QSST status. In some cases, the trust may qualify as an electing small business trust (ESBT). IRC §1361(e). See §14.13.

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§13.15 I. Generation-Skipping Transfer (GST) Tax Issues

Does the trust include any generation-skipping transfers? Are there any "direct skip" transfers to beneficiaries more than one generation below the settlor? Are there any transfers to continuing trusts with beneficiaries more than one generation below the settlor? See §13.40.

PRACTICE TIP: Generation-skipping problems are not limited to multimillion-dollar estates. A common trust plan provides for a trust for a child until a certain age. If the child dies before attaining that age, the trust will be distributed to (or continue for the benefit of) the deceased child's issue. Many attorneys do not recognize that this common trust is potentially subject to GST tax. The ongoing trusts for children in the hypothetical in §13.81 are potential GST trusts. In the hypothetical, the amount received by the children in trust ($3,735,000) exceeds the settlor's GST exemption. Therefore, there is a possibility that a small portion of the trust may be subject to GST tax if one or both of the children dies before age 35 leaving issue, unless each child has a testamentary power of appointment over his or her share of the trust. For this reason, it may be desirable to divide each child's trust into two trusts, only one of which will receive an allocation of GST exemption, so that any distributions to children can be made first from the other trust. In the hypothetical, each child would have an exempt trust of $1,750,000 and a nonexempt trust of $117,500. Look for language in the trust instrument directing a child's trust to be divided between "exempt" and "nonexempt" trusts or for a provision authorizing the trustee to divide single trusts into two separate trusts for this purpose. This division must be made on a fractional basis, although the fraction may be determined by a pecuniary formula. Treas Reg §26.2642-6(d).

If trusts must be divided for purposes of allocating GST exemption, determine whether the trustee has authority under the instrument to make the division or whether court proceedings are required. If the trust document is silent on this issue, it may be necessary to file a court petition to divide a single trust into two trusts. Prob C §15412.

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§13.15A m. Power to Divide Trusts

Determine whether the trust instrument prohibits or is silent on division of a trust into separate trusts. If it is silent, Prob C §15412 permits a petition to the court requesting such a division.

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§13.15B n. Payment of Interest

Does the trust instrument waive the requirement of interest on pecuniary gifts? If the instrument does not waive interest, a pecuniary gift bears interest beginning 1 year after the settlor's death. Prob C §§12003, 16340(b). See §14.44.

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§13.15C o. Gift Provisions

Does the trust instrument provide for an agent to make annual exclusion gifts under a durable power of attorney? If the trust instrument is silent, the settlor's exemption may be reduced by the amount of the gifts made by the agent. See §13.38.

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§13.16 p. Disqualified Persons

Review the trust instrument to determine whether any beneficiaries are "disqualified persons" under Prob C §§21350 and 21352. These provisions invalidate donative transfers to (Prob C §21350):

- The person who drafted the instrument;
- Any person who has a fiduciary relationship with the transferor, or who transcribed the instrument or caused it to be transcribed (see *Rice v Clark* (2002) 28 C4th 89, 120 CR2d 522; *Estate of Swettman* (2000) 85 CA4th 807, 102 CR2d 457);
- Any person who is related by blood or marriage to, is a California-registered domestic partner of, is a cohabitant with, or is an employee of any these persons;
- Any partner, shareholder, or employee of a law firm in which the drafter has an ownership interest; and
- Any care custodian of a dependent adult transferor, regardless of whether the person received compensation for acting in that capacity (see *Bernard v Foley* (2006) 39 C4th 794, 47 CR3d 248; *Estate of Odian* (2006) 145 CA4th 152, 51 CR3d 390).

Exceptions exist when (Prob C §21351):

- The transferor is related by blood or marriage to, is a cohabitant with (for definition of cohabitant, see Pen C §13700), or is the registered domestic partner (see Fam C §§297-299.6) of, the person who drafted the instrument;
- The instrument is reviewed by an independent attorney who determines that the intended transfer is not the result of fraud, menace, duress, or undue influence, and who signs a "certificate of independent review";
- The court determines, on clear and convincing evidence, that the transfer was not the product of fraud, menace, duress, or undue influence; or
- The transfer does not exceed $3000, except as specified.

For further discussion of transfers to disqualified persons, see California Trust and Probate Litigation, chap 6A (Cal CEB 1999).

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§13.17 q. Ambiguities and Drafting Errors

Does the trust instrument contain any unclear or ambiguous provisions that require interpretation or clarification by court order? For example, a trustee or beneficiary of a trust may petition the court concerning the trust's "internal affairs," including "determining questions of construction of a trust instrument" and "ascertaining beneficiaries and determining to whom property shall pass." Prob C §17200(b)(1), (4). Statutory rules pertaining to construction of wills apply to trusts and other instruments, including deeds. Prob C §21101. Applicable rules of construction include those relating to exoneration (see Prob C §21131) or ademption (see Prob C §§21134-21135) of specific gifts, preference against intestacy or failure of transfer (see Prob C §21120), and lapsing gifts (see Prob C §§21110-21111, 21114), as well as those relating to omitted spouses or registered domestic partners and children (see Prob C §§21600-21630). The statutory rules of construction of wills relating to automatic revocation on dissolution or termination of a marriage or domestic partnership do not apply to trusts. See Prob C §§6122, 6122.1; Fam C §297.5(c). However, if a devise to a revocable trust in a pourover will fails because the trust was revoked, a backup devise in the will incorporating the trust document by reference creates a testamentary trust that is subject to those rules. *Estate of Coleman* (2005) 129 CA4th 380, 28 CR3d 282.

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§13.18 r. Asset Schedule

Review the asset schedule, if any, attached to the trust and determine whether the assets listed on the schedule were properly transferred into the trust before death. Poorly drafted asset schedules are common (*e.g.,* there may be an automobile or bank account listed on the asset schedule when, in fact, title is in the names of the decedent and another person as joint tenants). Consider whether listing the asset on the trust asset schedule has severed the joint tenancy. See Drafting California Revocable Trusts §5.22 (4th ed Cal CEB 2003).

Other examples of problem assets include IRAs, life insurance, annuities, and pay-on-death accounts. There may be an issue if the designated beneficiaries under these arrangements differ from the beneficiaries who would take the asset under the terms of the trust. See *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433, discussed in §13.26.

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§13.19 2. Pourover Will

Ascertain whether there is a pourover will and whether assets outside the trust are subject to distribution under the will. Determine whether a probate proceeding is required for assets outside the trust or the assets can be collected or distributed through summary administration procedures. See §13.28. If personal property items were not funded into the revocable trust, consider how the disposition of these items will be handled. In the absence of a court-appointed executor, who is responsible? Who is nominated as executor and alternate executor? Is it the same person or persons as the trustee under the living trust? Are there any codicils? Does the will contain an estate tax clause? If so, is it consistent with the estate tax clause in the trust? See §13.9.

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IV. STEP TWO: FIRST MEETING WITH CLIENT

§13.20 A. Have Documents Ready for First Meeting

The following forms should be ready for use at the first meeting with the client:

- **Informed written consent form.**
- **Information and documents needed.** See §13.84. See also §13.3. Documents the client still needs to supply may be circled, documents not needed may be crossed off the list, and a copy of the list may be given to the client at the conclusion of the meeting.
- **Authorization to disclose information.** See §13.87. Multiple undated copies of this form should be signed by the client to authorize collection of information on assets.
- **Beneficiary list.** See §13.88. The client should complete this form.
- **Asset collection sheet.** See §13.89. This form is used to collect information at the initial meeting, track letters to institutions, and aid in collecting assets throughout the trust administration process. See §§13.25-13.29.
- **Liabilities for the trust.** See §13.90. See also §13.30.
- **Instructions for tracking and paying medical, funeral, administrative, and personal expenses.** See §13.91. See also §13.34. This form is given to the client to explain the necessity for tracking various expenses during the administration process.
- **Expenses of last illness; funeral expenses; administration expenses.** See §13.92. See also §13.34.
- **Time Sheet.** See §13.93. If the trustee is going to request fees, he or she may use this form to document the fee request. See §13.54.
- **New matter/client intake sheet.** See §13.82. This form can be used to collect detailed information about the client for file opening and billing.
- **Conflict checklist.** See §13.85.
- **IRS Form SS-4, Application for Taxpayer Identification Number.** This form, to be signed by the client, may be used to obtain a taxpayer identification number for the trust. When a separate administrative trust will be established or there are ongoing successor trusts, each trust may need its own taxpayer identification number. See §§13.43-13.46.
- **Table of Trustee Duties.** For a table of trustee duties under the Probate Code, see §17.68.

PRACTICE TIP: The checklist at §13.2 is used throughout the trust administration. It is the single most important document for trust administration and should be used by the attorney as he or she conducts the first meeting with the client.

If the practitioner created the estate plan and feels confident that the prospective client will retain him or her, a certification of trust and affidavit of death, as well as a certification of trust for any ongoing trust, also may be prepared for the first meeting. See §13.62.

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§13.21 B. Identify Client and Ethical Issues

If the attorney is representing one child as trustee and other family members will receive distributions from the trust, the attorney must make clear that he or she (1) represents only the trustee and *not* the other family members and (2) represents the client only as a trustee and not as a beneficiary. In California, it is not correct for the attorney to say he or she "represents the trust," because the trust is not a separate legal entity. See *Goldberg v Frye* (1990) 217 CA3d 1258, 1267, 266 CR 483 (attorney for executor represented executor, not "the estate" or beneficiaries). See also *Borissoff v Taylor & Faust* (2004) 33 C4th 523, 15 CR3d 735 (successor trustee has standing to sue attorneys of predecessor trustee for malpractice).

If representation will be joint, potential conflicts of interest should be discussed and the attorney should obtain informed written consent before proceeding with the representation. See Cal Rules of Prof Cond 3-310. See discussion in House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel 18, 32 (State Bar of California 2008 ed).

Consider the attorney-client and work product privileges and the attorney's duty of confidentiality in deciding whether to include other beneficiaries and family members in conferences. Excluding family members too overtly, however, can create hostility that will later impair administration.

Communications between the attorney and the trustee may not be privileged. See *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317 (successor trustee can discover advice of trust counsel to predecessor trustee about trust administration matters). See also *Eddy v Fields* (2004) 121 CA4th 1543, 18 CR3d 487 (without reaching apparent conflict posed by statutory work product privilege and client's right to his or her file, court held that if work product privilege was waived by attorney with respect to predecessor trustee it was also waived as to successor trustee). But see *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 91 CR2d 716 (beneficiaries generally have no right to discover trustee attorney-client communications or attorney work-product). For further discussion of these cases, see California Trust and Probate Litigation §21.50A (Cal CEB 1999). See also Streisand, *To Tell the Truth (the T&E Lawyer's Version): Will My Real Client Please Stand Up?*, Estate Planning 2006, chap 9 (Cal CEB 2006).

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§13.22 C. Connect With the Client

Because the first meeting with the client is the most critical point in the entire trust administration process, inexperienced attorneys should practice for this meeting. The author suggests the use of flip charts and software programs.

Generally speaking, the practitioner's first task is to establish a rapport with the client. Delay technical talk until the client is comfortable and then be aware of points at which the client has reached his or her limits of understanding. Remember that the client is grieving. Make sure the client understands that you care. The client is likely to be traumatized by recent events, particularly if the event is the death of a parent.

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§13.23 D. Begin to Educate Client About Realities of Trust Administration

At the first meeting, the attorney is engaged in both a fact-finding process and an educational mission, in the sense that the client needs to understand the complexities involved in trust administration. As mentioned previously in §13.3, the client frequently believes the living trust myth that administration of living trusts is simple and free of expenses. The first meeting is important in dispelling this belief. Many individuals have turned to living trusts to avoid the necessity and cost of a court probate proceeding, but their expectations often exceed reality. In fact, most successor trustees require professional help to carry out their fiduciary responsibilities, which often comes as a shock to the successor trustee and the beneficiaries. Even if a fully funded revocable trust is in place, trust administration requires structure and formality, with concomitant legal and accounting fees.

CAUTION: It will be impossible in the first meeting to cover in depth all of the topics the trustee must become aware of (these topics are discussed in §§13.24-13.56). In fact, after two or three hours, the client may have reached a saturation point. To introduce more information at this point, all of which may be unfamiliar, will only confuse the client. It is up to the attorney to judge which of the topics discussed below should be covered at the first meeting, and in what detail, and which topics can be best introduced at later meetings.

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§13.24 E. Summarize Trust Provisions and Administration Process for Client

In the broadest terms, explain the trust instrument to the client and present an overview of the distribution scheme. If there are continuing trusts, the trustee should understand their basic operation and the scope of the trustee's discretion and authority in making distributions to the successor trusts.

The client should leave the first meeting with an overall view of the trust, his or her fiduciary duties, an outline of the steps involved in the administration process, and a list of specific actions to take next.

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§13.25 F. Collect Preliminary Asset Information

The key to successful trust administration is timely and complete asset collection. Information about the trust assets is vital for completing the federal estate tax return (IRS Form 706), among other reasons. Therefore, the extent and form of title of the decedent's assets must be determined as soon as possible. Look for any ambiguous or unclear issues with respect to the assets. Early recognition of potential uncertainties is vital to a successful administration. Prepare an initial inventory of assets during the first meeting. See §13.89.

Assets generally fall into one of three categories:

- Assets in the trust;
- Assets not in the trust that pass outside of probate; and
- Assets not in the trust that require probate or summary administration.

As asset information is collected, enter it into an asset allocation spreadsheet and fiduciary accounting program. For a discussion of creating spreadsheets to list assets, see §14.14.

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1. Title to Assets

§13.26 a. Assets in the Trust

The successor trustee has a fiduciary obligation to marshal and safeguard trust assets. The starting point is the asset schedule attached to the trust instrument, which provides a snapshot of the assets transferred to the trust (or at least intended to be transferred to the trust) at its inception.

Listing assets on a schedule attached to the trust may be legally sufficient to bring the assets into the trust, at least for a self-declaration of trust when there is language of grant or assignment in the instrument. Prob C §850(a)(3)(B); *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433 (listing property interest on asset schedule attached to trust was sufficient when trust instrument included language showing decedent's express intent to hold property in trust). See §15.39A. Under Evid C §662, the owner of legal title to property is presumed to be the owner of the full beneficial title, and this presumption may be rebutted only by clear and convincing proof. One view is that an express declaration that property has been transferred to the trust on a schedule attached to the trust is sufficient to rebut this presumption, and establishes that the property was intended to be held in trust, even when the property is transferred back to the settlor's name individually. See *Estate of Heggstad, supra*. See also *Heaps v Heaps* (2004) 124 CA4th 286, 21 CR3d 239, discussed in §14A.24.

Another view is that the transfer of property out of the trust evidences an intent to revoke the trust under Prob C §15401(a)(2) as it applies to the asset, and that the last act of transferring the property out of trust takes precedence over its initial listing on a schedule attached to the trust. See *Osswald v Anderson* (1996) 49 CA4th 812, 57 CR2d 23. However, this argument makes little sense where the decedent has a pourover will, in which case the property will pass under the terms of the trust in any event. In that case, it seems unreasonable to conclude that the decedent intended to revoke the trust as to that asset, when the ultimate disposition of the property is unaffected by the transfer out of trust, albeit only after the property is transferred pursuant to the trust through a full probate administration.

PRACTICE TIP: Because brokerage firms, banks, and title companies often do not comply with the ruling in *Heggstad,* it may be necessary to bring a petition under Prob C §850(a)(3)(B) to determine that an asset is part of the trust.

When the decedent has a pourover will and the value of the decedent's nontrust assets that do not pass by nonprobate transfer does not exceed $100,000, the trustee may collect those assets without a formal probate under Prob C §13100. See 1 California Decedent Estate Practice §3.11 (2d ed Cal CEB 2009).

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§13.27 b. Assets Outside Trust Subject to Distribution by Will

The trustee has no legal authority to deal with assets outside the trust, yet he or she must determine the nature and extent of assets to be reported on the estate tax return when there is no executor. The trustee may also be obligated to collect into the trust assets that pass to the trust through probate or otherwise. See Prob C §§16006, 16010. Distribution of some nontrust assets may be governed by the decedent's will, including provisions that pour over assets to the trust.

The practitioner must determine whether formal probate is necessary to collect assets outside the trust.

NOTE: Absent a showing of good cause, if the named executor fails to file a petition for probate within 30 days after the person has knowledge of the nomination and the decedent's death, the person may be held to have waived the right to appointment as personal representative. Prob C §8001.

The practitioner also should consider whether summary administration is available to collect assets outside the trust. See Prob C §§13100, 13150, 13200.

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§13.28 c. Assets Outside Trust Not Subject to Distribution by Will

The decedent's estate may include assets outside the trust that are not subject to probate and, therefore, are not governed by the terms of the pourover will. These assets may include life insurance proceeds, retirement plan benefits, annuities, joint tenancy property, and "pay-on-death" accounts. See 1 California Decedent Estate Practice, chap 4 (Cal CEB 1986).

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§13.29 2. Other Basic Information Concerning Assets

In addition to reviewing title to the assets, the practitioner should discuss the following possible actions at the first meeting with the client:

- **Determine whether legal action is required to collect assets into trust.** If there are assets in the hands of a third party that the trustee believes belong to the trust (*e.g.,* purported gifts made when the decedent lacked capacity), develop an action plan to recover the assets as soon as possible. Discuss the need for litigation against third parties. See Prob C §17000.1(b). See also California Trust and Probate Litigation §22.12 (Cal CEB 1999).
- **Estimate value of assets.** An estimate of the value of the assets provides a basis for making a rough estimate of the estate tax liability and addressing liquidity concerns.
- **Discuss need for appraisals.** Formal appraisals of real and personal property are required to establish the new income tax basis and for estate tax purposes. The responsibility for hiring the appraisers should be discussed. Note that any appraisals prepared by an appraiser hired by the attorney that are not submitted to the taxing authorities may be privileged and not subject to discovery in a subsequent tax proceeding.
- **Identify need for investment advice and make referral to broker.** Analyze the trust's investment portfolio and consider referring the client to a broker for advice regarding the retention or sale of securities. Consider whether investment advisor fees are excepted from the 2-percent floor on itemized deductions under IRC §67(e). See §9.45A.
- **Identify dividend reinvestment accounts.** Determine whether the trust includes any mutual funds or securities accounts with dividend reinvestment plans. If so, advise the trustee to terminate the dividend reinvestment plan and take the dividends in cash. Taking dividends in cash may be preferable because (1) dividend reinvestment plans cause complexities in fiduciary accounting; (2) it may be inappropriate for the trustee who is charged with distributing the trust to invest trust income in securities; and (3) the trust may need the cash dividends for liquidity purposes.
- **Identify out-of-state real property.** Discuss the need for ancillary probate or summary administration proceedings for nontrust real property located in other states. Consider whether preparing grant deeds or other transfer deeds for property located in states where the attorney is not licensed constitutes the unauthorized practice of law. Discuss the need for retaining an out-of-state attorney to handle those procedures.
- **Identify depreciating or wasting assets.** Identify depreciating or wasting assets and advise the client regarding their immediate disposition. Review the trust for clauses limiting the trustee's power to dispose of assets, and consider whether doing so may frustrate the purpose of the trust, the settlor's intent, or the rights of a beneficiary.
- **Identify assets subject to special regulatory or contractual controls.** Identify assets subject to special licensing requirements, regulatory agency control, or contractual provisions (*e.g.,* Federal Communications Commission requirements for interests in radio or TV stations, Bureau of Alcohol, Tobacco, and Firearms requirements for interests in wineries, Department of Alcoholic Beverage Control requirements for transfer of liquor licenses, contractual prohibitions, or consent requirements for transfers of franchisee interests). Determine how to proceed.
- **Identify safe deposit boxes and arrange for inventory.** Determine whether the decedent maintained safe deposit boxes with any financial institutions. If so, discuss arrangements with the client for locating keys or obtaining authority for access, and for inventorying the contents.
- **Discuss insurance coverage.** Discuss the adequacy of insurance coverage on trust real and personal property.
- **Identify assets subject to options, escrows, or foreclosures.** Identify any assets subject to option agreements triggered by death or otherwise or any real property in escrow or foreclosure at the time of the decedent's death.
- **Identify hazardous waste problems.** Determine whether real property in the trust has potential hazardous waste problems. Review the trust instrument for provisions dealing with the trustee's responsibility for

environmental problems, and discuss the scope of investigation or environmental assessment needed. If environmental hazards are known or suspected, discuss whether the client should even accept the trust because of potential personal liability exposure. For a discussion of trustee liability for cleanup of contaminated trust property, see chap 6. For a client questionnaire on toxics, see §13.94. It may be advisable to have the client complete the questionnaire before the client accepts the position of trustee.

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§13.30 G. Collect Liability Information and Consider Use of Trust Claims Procedure

The assets of a trust revocable by the settlor at death are subject to creditors' claims and to payment of administration expenses if the estate is insufficient. Prob C §19001(a). Advise the trustee of this liability. See chap 10.

Collect information on the nature and amount of the decedent's outstanding liabilities, including the amount of debts and outstanding loans and whether they are secured or unsecured. See §13.90. Identify potential creditors with contingent claims. In addition, determine whether the decedent is a defendant in any lawsuits pending at the time of death.

Consider use of the optional creditor claims procedure for living trusts (see Prob C §§19000-19403), which essentially mirrors the creditor claims procedure applicable to a probate (Prob C §§9000-9399). See chap 10A.

NOTE: There is a 1-year statute of limitations for all actions against the decedent for which the statute of limitations has not run at the time of the decedent's death. CCP §366.2. This statute applies to claims against a living trust. See CCP §366.2(b)(3). There is also a 1-year statute of limitations that applies specifically to any claim arising from an agreement with a decedent for distribution from an estate or trust or under another instrument. CCP §366.3. Relying on these sections without sending the notice required for proceedings under Prob C §§19000-19403 may violate constitutional due process or be barred by equitable estoppel. See §§10A.5-10A.6.

For full discussion of creditors' claims and sample forms if the Prob C §§19000-19403 procedure is used, see chap 10A.

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§13.31 H. Discuss Fiduciary Duties

The rules governing the trustee's duties in the operation of the trust are derived from the trust instrument, statutes, and case law. The provisions of a trust may override general provisions of the Trust Law (see Prob C §16000) except when a paramount public policy exists (see Prob C §21103).

The practitioner should explain that a trustee occupies a position of trust and confidence and then discuss the trustee's fiduciary duties, which include the duty

- To administer the trust;
- Of loyalty;
- To deal impartially with beneficiaries;
- To avoid conflict of interest;
- Not to undertake an interest adverse to the trust;
- To take control of and preserve trust property;
- To make trust property productive;
- To keep trust property separate and identified;
- To enforce claims;
- To defend actions;
- Not to delegate (with an exception);
- With respect to cotrustees;
- To use special skills;
- To notify beneficiaries (see §13.32); and
- To report, account, and furnish information (see §13.33)

Prob C §§16000-16015, 16060, 16061, 16061.5, 16061.7, 16062, 16080, 16200. See also Prob C §§16045-16054 (Uniform Prudent Investor Act). For discussion of trustee duties, see chap 2; §§7.1-7.2.

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§13.32 1. Duty of Notification

Under Prob C §16061.7, the trustee must send a notification to current beneficiaries and heirs at law when a revocable trust or any portion of it becomes irrevocable because of the death of one or more of the settlors or because of a contingency as specified in Prob C §16061.7(a)(1) or when there is a change of trustee of an irrevocable trust. For sample form, see §13.95. The notification must include a statement that the recipient is entitled, on reasonable request to the trustee, to receive from the trustee a true and complete copy of the terms of the trust. Unless the notification is served only because of a change of the trustee, it must include the warning that the recipient has a specified limited amount of time in which to bring an action to contest the trust. See *Harustak v Wilkins* (2000) 84 CA4th 208, 100 CR2d 718, holding that a notice sent pursuant to §16061.7 that was not boldfaced or otherwise distinguished from the remaining text was insufficient to bar an action. But see *Germino v Hillyer* (2003) 107 CA4th 951, 132 CR2d 478, distinguishing *Harustak*, holding that notice was sufficient even though it did not include the language permitting the beneficiaries to request a copy of the trust (Prob C §16061.7(g)(5)), when the beneficiaries actually received a copy of the trust and the boldface statute of limitation notification was provided (Prob C §16061.7(h)).

The client should be informed that notification must be served personally or by mail on each beneficiary or heir entitled to receive it at the last known address within 60 days of the occurrence of the event requiring service of the notification (*e.g.,* the death of the settlor) and therefore it is important to gather the names and addresses as quickly as possible. Prob C §16061.7.

The effect of a notice served beyond the 60-day period is uncertain under the statutory scheme. Probate Code §16061.8 provides that service of notice "pursuant to this chapter" starts the running of the statute of limitations for filing a contest. Because this statute also provides for a 60-day limitation period, notice that is served more than 60 days after the triggering event arguably does not constitute notice "pursuant to this chapter" within the meaning of the statute. Consequently, the statute of limitations may never begin to run when notice is served late. The author believes that this is merely a technical defect in the statute. A more reasonable reading of the statute would be that the statute of limitations begins to run from the date the last notice is served. Even if this interpretation is correct, it is still important to serve the notice within 60 days whenever possible, because the trustee may be liable for any damages resulting from delayed service. Prob C §16061.9.

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§13.33 2. Duty to Report, Account, and Furnish Information

In explaining to the client why it is necessary to keep thorough and accurate records of all transactions and acts undertaken as trustee, the attorney should inform the trustee at the beginning of the trust administration of the trustee's duty to keep beneficiaries (as defined in Prob C §24) reasonably informed of the trust administration (Prob C §16060) and to account. See *Salter v Lerner* (2009) 176 CA4th 1184, 1188, 99 CR3d 1, discussed in §7.54A.

The trustee must account (Prob C §16062(a)):

- At least annually;
- At the termination of the trust; and
- On a change of trustees to each beneficiary to whom income or principal is required or authorized to be currently distributed.

For information on the contents of the account and the manner of presentation, see Prob C §16063. For a thorough discussion of recordkeeping and accounting, see chap 7.

In addition to mandatory annual accountings to current beneficiaries, the trustee must provide *any beneficiary* as defined in Prob C §24(c) (*i.e.,* even those not currently entitled to distributions), on reasonable request, with a report of information about the assets, liabilities, receipts, and disbursements of the trust; the acts of the trustee; and the particulars relating to the administration of the trust relevant to the beneficiary's interest, and the trustee must also provide the beneficiary with a complete copy of the terms of the trust. Prob C §§16061, 16061.5. See §2.20. This requirement is frequently referred to as the "duty to report." The author is aware of a proposal in the legislature to modify this requirement to provide that the duty to report cannot be waived by those entitled to it.

NOTE: The precise scope of a beneficiary's right to inspect trust records is unclear. The only guidance in this regard was provided by the California Supreme Court in *Strauss v Superior Court* (1950) 36 C2d 396, 224 P2d 726. Although the court held that a beneficiary was entitled to inspect the records of the trust on the facts of that case, it remains uncertain whether a beneficiary is entitled to copy trust records, and who is obligated to pay for any copying expenses. Some courts believe that all beneficiaries, as broadly defined in Prob C §24, have an absolute right to inspect trust records.

PRACTICE TIP: The mandatory accounting requirements generally apply to trusts created on or after July 1, 1987. The duty to report information required under Prob C §16061, however, appears to apply to all trusts regardless of when created. See Prob C §15001. Even if the trust is grandfathered in or waives the requirement of an account, the author generally recommends that the trustee provide an accounting voluntarily, and that this be discussed in the initial meeting with the client. Internal accountings will be needed to provide a permanent record of trust transactions, to distinguish between principal and income transactions, and to provide a source of data for the preparation of fiduciary income tax returns. Because this information has to be assembled anyway, it is not onerous to take the next step and provide this information to the beneficiaries. Withholding this information may lead to suspicion and litigation. Making an accounting may help the beneficiaries better understand and appreciate the work of the trustee. It may also help avoid misunderstandings by disclosing all relevant transactions. Most important, making an account will start the running of the 3-year statute of limitations in Prob C §16460 for all matters disclosed in the accounting, even if the account does not strictly satisfy the requirements of Prob C §16063. See *Noggle v Bank of America* (1999) 70 CA4th 853, 82 CR2d 829. The terms of the trust may shorten the 3-year statute of limitations to as little as 180 days. Prob C §16461. See §7.65.

PRACTICE TIP: Even if court approval is not required, if disputes may arise or if there are disgruntled family members or beneficiaries, consider presenting the trustee's accounting to the court for approval (Prob C §17200(b)(5)) because this will reduce the statute of limitations to the time of appeal from the court's order. See Prob C §1300(b); Cal Rules of Ct 8.104(a).

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§13.34 I. Discuss Trust Checking Account, Expenses, and Liquidity Needs

At the first meeting with the client, the practitioner should advise the client to establish a checking account in his or her name as trustee, using the taxpayer identification number obtained for the trust. See §13.20. Advise the client to use this account for all cash receipts and disbursements and explain the importance of doing this to facilitate the preparation of the account and report.

Explain what expenses should be paid from the trust checking account and what expenses, if any, should be paid by the trustee or beneficiaries individually. See §13.91. Also instruct the client on tracking and paying medical, funeral, administrative, and personal expenses and expenses of the decedent's last illness, and give the client a form like the one displayed in §13.92.

Because the client, by the time of the first meeting, may have paid some administrative expenses out of his or her personal funds or out of nontrust assets such as a joint tenancy bank account, determine what expenses are properly chargeable to the trust, the amount paid, and the source of payment. Advise the trustee to request copies of receipts for such expenses and to reimburse the person or persons who paid them.

Include in the discussion of current expenses an assessment of the trust's liquidity needs for debts, taxes, and administration expenses, including attorney fees, trustee fees, CPA fees, and the like.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ J. Discuss Estate Tax Issues/§13.35 1. IRS Form 706 and State Tax Returns

J. Discuss Estate Tax Issues

§13.35 1. IRS Form 706 and State Tax Returns

The client should be informed that a federal estate tax return (IRS Form 706) is required when the gross estate exceeds a certain dollar amount, called the applicable exclusion amount, and told what the amount is for the year of the decedent's death. The following table gives the applicable exclusion amount (IRC §2010(c)) and maximum/minimum estate tax rate (IRC §2001(c)) for years 2002-2011:

Year of Death	*Applicable Exclusion Amount*	*Maximum Federal Estate Tax Rate*	*Lowest Federal Estate Tax Rate*
2002	$1,000,000	50%	41%
2003	$1,000,000	49%	41%
2004	$1,500,000	48%	45%
2005	$1,500,000	47%	45%
2006	$2,000,000	46%	46%
2007	$2,000,000	45%	45%
2008	$2,000,000	45%	45%
2009	$3,500,000	45%	45%
2010	(repealed)	(repealed)	0%
2011	$1,000,000	55%	41%

NOTE: The gift tax applicable exclusion amount remains $1 million. IRC §2505. The repeal of the estate tax is effective for 1 year only in 2010. If Congress does not revisit this issue before 2011, the estate tax applicable exclusion amount will automatically revert to the amount scheduled to apply under former law.

No estate tax is currently imposed by the state of California. Technically, the California estate tax remains on the books, but it is structured as a "pick-up" tax equal to the amount of the federal estate tax credit for state death taxes attributable to the decedent's California property (IRC §2011; Rev & T C §§13302-13304). The credit for state death taxes under IRC §2011 is repealed for estates of decedents dying after 2004 and before 2011. Because the California estate tax was tied to the federal estate tax credit, the repeal also effectively repealed the California estate tax.

However, the client should be informed that it may be necessary to file returns for property in other states that have an inheritance tax or an estate tax other than a pick-up tax, or that have a pick-up tax defined with reference to an applicable exclusion amount less than the current amount (*e.g.*, $1 million in New York) with the consequence that estate tax may be owed in these states. Because the state death tax credit ranges from 6.4 percent for taxable estates in excess of $1,100,000 to a maximum of 16 percent for taxable estates in excess of $10,100,000 (see §12.55B), the client may expect that property in these states will be taxed at the same rates. The tax impact will be partly offset by the IRC §2058 deduction for state death taxes paid. For example, the estate of a decedent with $2,100,000 of property in one of these other states may expect to pay $68,000 in state estate taxes and save $30,600 in federal estate tax, for a net tax of $37,400. As of this publication, 17 states and the District of Columbia have estate taxes that are "decoupled" in this way, and several states have stand-alone estate or inheritance tax systems. For a survey of state estate and inheritance taxes in other states, see Estate Planning for Special Assets, chap 5 (Cal CEB 2004).

PRACTICE TIP: As early in the process as possible, the attorney should decide whether to obtain an extension to file Form 706 and/or pay the tax if the trust administration is starting late (*e.g.,* when the successor trustee has

delayed several months before seeking professional assistance).

Inform the client that, if Form 706 is required, it probably will be necessary to obtain formal appraisals of the fair market value of various assets to help establish the values that will be reported on the return. The value of an asset as appraised for federal estate tax purposes (or if no estate tax return is required to be filed, its value as appraised for state tax purposes) is deemed to be its fair market value at the date of the decedent's death for purposes of determining the income tax basis of the asset. Treas Reg §1.1014-3(a). Expert appraisals generally must be provided for household and personal effects having a value in excess of $3000 (*e.g.,* jewelry, art, antiques, coin or stamp collections). Treas Reg §20.2031-6(b).

CAUTION: If the decedent owned real property in states other than those in which he or she resided, discuss with the client the possible need for estate tax filings in those other states.

As part of the process in determining the gross value of the estate, inform the client that it is necessary to identify assets includable in the estate, *e.g.,* under IRC §§2035 (gifts within 3 years of death), 2036 (retained interests, *e.g.,* life estates), 2037 (transfers with a retained reversionary interest), 2038 (revocable transfers), 2041 (powers of appointment), and 2044 (QTIP property), that are not actually owned by the decedent or the trust.

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§13.35A 2. Alternate Valuation Date Election

Assets may be valued for federal estate tax purposes as of the alternate valuation date, which is 6 months after the date of death. IRC §2032(a)(2). If assets are sold or distributed to beneficiaries before that date, however, the date of disposition is the alternate valuation date for those particular assets. IRC §2032(a)(1). Alternate valuation is elected on the estate tax return and may be elected on a late return filed within 1 year of the return's due date, including extensions. IRC §2032(d); *Estate of Edward H. Eddy* (2000) 115 TC 135. The IRS may grant an extension to make the election within the 1-year period even after a timely estate tax return has been filed. See IRS Letter Rulings 200419005, 200236041, 200234037, 200227029.

PRACTICE TIP: It is extremely useful to use an outside service for evaluating stocks and bonds. Once entered into the system, the trustee can regularly value the assets to determine whether an early distribution should be made to lock in an alternate valuation date for assets.

Alternate valuation is an all-or-nothing proposition. Alternate valuation is available only if the estate tax payable is reduced. IRC §2032(c). In other words, alternate valuation cannot be used for the sole purpose of securing a larger step-up in income tax basis in a nontaxable estate. If security holdings are significant, discuss with the client the advisability of cost averaging, selling, or distributing securities that have declined in value between the date of death and the alternate valuation date, thereby locking in reduced values for the stocks sold or distributed during the 6-month period for alternate valuation.

The importance of alternate valuation cannot be overstated, as it offers a significant opportunity to reduce estate taxes. Due to the time-sensitive nature of alternate valuation, monitoring of assets for valuation purposes should begin at the earliest opportunity, and asset values should be periodically reviewed until the alternate valuation period ends.

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§13.36 3. Special Use Valuation Election and Other Estate Tax Elections

Consider estate tax elections, such as the special use valuation election available under IRC §2032A, which permits a reduction of up to $1,000,000 for decedents dying in 2009 ($960,000 for decedents dying in 2008, $940,000 for decedents dying in 2007) in value of a qualifying farm or other closely held business from a decedent's estate. The reduction limitation is adjusted annually for inflation. IRC §2032A(a)(3). See §§12.22-12.24.

Consider the election available under IRC §6166, which provides for the installment payment of estate taxes attributable to closely held businesses. See §12.27.

Internal Revenue Code §2031(c) permits an exclusion of up to 40 percent of the value of real property subject to a qualified conservation easement, up to a limit of $500,000. For discussion, see §12.29.

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§13.37 4. Prior Transfer Property Credit

To take advantage of the prior transfer property (PTP) credit available for estate taxes paid with respect to prior transfers to the decedent, the practitioner should advise the trustee to identify property that passed to the decedent through a taxable estate within 10 years before death. IRC §2013.

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§13.38 5. Taxable Gifts

Review prior gifts made by the decedent and determine whether any gift tax returns were ever filed. See §13.71. If the decedent made any inter vivos gifts in excess of the annual exclusion amount, consider the need to file gift tax returns to report the gifts. Any gift made from a revocable trust is treated as a gift by the settlor. IRC §2035(e). It is possible that the decedent made inter vivos gifts for which it would be beneficial to file a timely gift tax return and allocate the generation-skipping transfer (GST) tax exemption (*e.g.,* gifts to a life insurance trust). See §13.15.

Annual exclusion gifts must be completed before death to avoid being brought back into the estate. A gift made by check is generally incomplete if the check does not clear the drawer's bank before death, because the drawer has the ability to stop payment until the check clears. Under the relation-back doctrine, a gift will be deemed to have been made on the date the payee deposits the check rather than the date the check clears, but only if the donor is still living when the check clears. *Estate of Sarah H. Newman* (1998) 111 TC 81. See also *Rosano v U.S.* (2d Cir 2001) 245 F3d 212.

In certain cases, the IRS may disallow annual exclusion gifts made by multiple settlors to related beneficiaries. In *Sather v Commisioner* (8th Cir 2001) 251 F3d 1168, the court held that gifts made by each of three brothers to trusts benefiting children of the other brothers were gifts to the trust benefiting each donor's own children for annual exclusion purposes, under the reciprocal trust doctrine in *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730.

When an agent makes gifts under a durable power of attorney that does not specifically authorize gifts, it is possible that annual exclusion gifts may be brought back into the taxable estate. See IRS Letter Rulings 9347003, 9601002. See also *Estate of Swanson v U.S.* (Fed Cir 2001) 2001-1 USTC ¶60,408, 87 AFTR2d 2345, in which the court applied California law and held that gifts made were void because the instrument did not expressly authorize the agent to make gifts, as required by Prob C §4264(c). But see *Estate of Ridenour v Commissioner* (4th Cir 1994) 36 F3d 332; *Estate of Rosa B. Neff,* TC Memo 1997-186; and IRS Letter Ruling 9708004, in which gifts were not brought back into the estate when state law did not require that the durable power of attorney expressly authorize gifts. Note that a California Uniform Statutory Form Power of Attorney arguably may be used for gifting, even when gifting is not expressly included in the powers granted. See Prob C §4401.

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§13.39 6. Disclaimer Planning

Warn the client not to rush to make distributions to beneficiaries. Making distributions too quickly might disrupt potential disclaimer planning because of the "acceptance of benefits" rule. See IRC §2518(b)(3). Note, however, that acceptance of discretionary distributions may not prevent a disclaimer of remainder interests in the same trust. See Treas Reg §§25.2518-3(a)(1)(i), 25.2518-3(d), Examples (10), (11). Note further that any action taken by a beneficiary (or custodian) before the beneficiary's 21st birthday is not considered an acceptance by the beneficiary for federal estate and gift tax purposes. Treas Reg §25.2518-2(d)(3); IRS Letter Ruling 200838026 (minor beneficiary may disclaim trust interests within 9 months after attaining age 21 despite acceptance of benefits). It is also possible for a guardian to disclaim on behalf of a minor with court approval. Prob C §277. Such disclaimers may be challenged by the IRS to the extent that they appear inconsistent with state law. See *Estate of Robert W. Goree, Jr.*, TC Memo 1994-542 (disclaimer by minor with court approval was held consistent with Alabama law after IRS challenge); IRS Letter Ruling 200130034 (IRS approval of disclaimer by minor conditioned on being valid under state law).

The client also must be careful in making distributions to successor beneficiaries in the event of a disclaimer because the named beneficiary may have accepted an interest in the trust even before the property is distributed, with the consequence that the beneficiary's creditors may be entitled to the property and the trustees may be liable for distributions to the successor beneficiaries. See *Cassell v Kolb (In re Kolb)* (9th Cir 2003) 321 F3d 868; *Cassell v Globerson (In re Kolb)* (Bankr ND Cal, May 29, 2007, No. 97-32321) 2007 Bankr Lexis 1896, discussed in §10.38.

Be alert to conflicts of interest in advising beneficiaries on disclaimer planning issues. In a single-settlor situation, consider disclaimers as a means to:

- Perfect or increase a charitable deduction gift;
- Avoid general powers of appointment in ongoing trusts;
- Skip a generation;
- Qualify for stock redemption under IRC §303;
- Eliminate nonqualified heirs in order to qualify for the special tax election under IRC §2032A; see §13.36;
- Avoid multiple administrations and unnecessary death taxes;
- Terminate a trust;
- Avoid income taxes; or
- Accelerate estate tax to qualify for the prior property transfer credit. See §13.37.

In IRS Letter Ruling 200649023, for example, the IRS ruled that a disclaimer of a power of appointment that resulted in property passing to a foundation was qualified even though the disclaimant was a trustee of the foundation, because the trust document was amended before the disclaimer in a manner that created a separate fund for the property passing to the foundation as a result of the disclaimer. Explain to the client that the deadline for making disclaimers is generally 9 months from the date of death. IRC §2518(b)(2)(A).

Note that the United States Supreme Court has held that a preexisting tax lien attaches to an inheritance, notwithstanding a valid disclaimer. *Drye v U.S.* (1999) 528 US 49, 145 L Ed 2d 466, 120 S Ct 474. However, courts have held that a disclaimer of a debtor's interest in a trust within 30 days before filing bankruptcy is not avoidable by the bankruptcy trustee as a fraudulent conveyance because the *Drye* decision was based on federal tax statutes; bankruptcy statutes do not contain comparable provisions. *Gaughan v Edward Dittlof Revocable Trust (In re Costas)* (9th Cir 2009) 555 F3d 790; *Wood v Bright (In re Bright)* (BAP 9th Cir 1999) 241 BR 664. For a detailed discussion of disclaimers, see 2 California Decedent Estate Practice §14.25 (Cal CEB 1986). For discussion of disclaimer planning, see California Estate Planning, chap 27 (Cal CEB 2002).

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§13.40 7. Generation-Skipping Transfer (GST) Tax

When the gross estate exceeds $3.5 million and distribution is other than outright to children, consider allocation of the settlor's GST exemption. The amount of the GST exemption is the same as the IRC §2010 applicable exclusion amount for transfers before January 1, 2011. IRC §2631(c). See §13.35. Determine the amount of the GST exemption used before death, including deemed allocations. See §12.74.

If trusts must be divided for GST allocation purposes, determine whether the trustee has authority under the instrument or whether court proceedings are required. If there are ongoing trusts, determine whether the trustee has powers to confer a general power of appointment, and discuss the issue with the trustee.

For a checklist of GST issues, see Handling Postmortem Trust Administration: A Checklist (Cal CEB Action Guide September 2009). For further discussion of the GST tax, see Drafting California Irrevocable Trusts, chap 4 (3d ed Cal CEB 1997). See also California Will Drafting, chap 15 (3d ed Cal CEB 1992).

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§13.41 8. Coordinating With Insurance Trust

If the decedent established an irrevocable life insurance trust to provide for payment of estate taxes, determine how to obtain access to the cash in that trust. Consider the dispositive provisions of the insurance trust when making this determination. The trustee of an insurance trust cannot pay estate taxes directly, because that would result in inclusion of the proceeds in the decedent's estate. See IRC §2042; Treas Reg §20.2042-1(b)(1). The trustee of the revocable trust must either sell assets to, or borrow from, the irrevocable trust.

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K. Discuss Income Tax Issues

§13.42 1. Responsibility for Tax Returns

Allocate responsibility for the decedent's personal returns and fiduciary returns. Determine who will prepare and file the decedent's final personal income tax returns and the trust's fiduciary income tax returns. If probate is required because the trust was not fully funded, separate fiduciary returns may also be required for the probate estate, although one return may be used if the IRC §645 election is made. See §13.44. Consider referring the client to a CPA. See §§11.3-11.8.

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§13.43 2. Use of Administrative Trust

Determine whether to use an administrative trust. Absent any direction in the trust instrument that precludes its use, determine whether to use a separate taxpayer administrative trust for the period between the settlor's death and the date of distribution to the beneficiaries. See §13.44.

For further discussion of administrative trusts, see §§14.2-14.6.

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§13.44 a. Factors to Consider

The trustee's decision about whether to use an administrative trust may depend on the nature and extent of the assets and the anticipated duties of the trustee in carrying out the administration. Other factors may include whether assets will be sold inside the trust or distributed in kind. As a practical matter, unless there are no income-producing assets and the trust will be distributed quickly, this author recommends use of an administrative trust. This is especially true if distribution will be delayed indefinitely by litigation or difficulties in obtaining appraisals or if distribution will take place in the calendar year after the decedent's death (or other date elected by trustee).

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§13.45 b. Election to Treat Revocable Trust as Part of Estate

The trustee of a deceased settlor's revocable trust and the executor of the settlor's estate (if any) may elect to treat the trust as part of the estate for fiduciary income tax purposes. IRC §645. The procedure for making the election is governed by Treas Reg §1.645-1. For full discussion and form, see §§11.53-11.53C. If the election is made, the trust may use a reporting year other than the calendar year even if there are no probate proceedings. See §11.14. California has conformed with this rule. Rev & T C §§17751-17752.

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§13.46 c. Obtain Taxpayer Identification Number

If the decision is made to use an administrative trust, obtain a separate taxpayer identification number (TIN), also referred to as an employer identification number (EIN), for the living trust during the period of postdeath administration. In any event, TINs will be required for any ongoing successor trusts. Fill out IRS Form SS-4, and have the client sign the form at the first meeting.

The completed form may be faxed to the IRS. The IRS will fax the TIN directly to the client, unless the Third Party Designee box on the form is completed authorizing the IRS to provide the TIN to a third party or a completed IRS Form 2848 (Power of Attorney) is also faxed indicating that the TIN should be sent to the attorney. California taxpayers wishing to apply by fax should fax Form SS-4 to the Philadelphia Service Center at (859) 669-5760.

A taxpayer or authorized third-party designee may also obtain a TIN immediately by telephone by calling 1-800-829-4933 between 7:00 a.m. and 10:00 p.m. EST. The caller should have the completed Form SS-4 at hand so that all relevant information is available; the IRS representative may require that it be mailed or faxed to the IRS within 24 hours to an address provided by the representative.

IRS Form SS-4 Internet EIN is another avenue to apply for TINs; http://www.irs.gov will lead the client to the website to apply for a TIN.

As an alternative to obtaining TINs one at a time, blocks of numbers may be obtained from the IRS by writing to the EIN Operation of the designated Internal Revenue Service Center for your principal place of business: For California, write to Internal Revenue Service Center, Attn: EIN Operation, Philadelphia, PA 19255. See IRS Pub 1635. Once the required paperwork is filled out, numbers in groups of 10, 25, 50, 75, 100 (whichever is requested) will be mailed to you. Before obtaining the next block of numbers, a form must be faxed or mailed to the IRS showing which numbers have been assigned and the relevant information (*e.g.,* trust name, settlor, trustee). See also §13.20 and §§11.10-11.11.

IRS Form 56 (Notice Concerning Fiduciary Relationship) must be prepared and filed to notify the taxing authorities that the trust is now irrevocable and has become a separate taxable entity.

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§13.47 3. Returns to Be Filed; Estimated Taxes

Determine what tax returns need to be filed. Determine whether the decedent's personal returns for previous years were filed as required. Determine whether any income tax returns are required in states other than the state where the decedent was domiciled, *e.g.,* for income-producing real property located in another state. Calculate the period for final (short-year) personal returns (January 1 through the date of death) and the first short-year return for the trust (date of death through December 31). See §§11.42-11.46.

As a general rule, trusts are required to pay quarterly estimated taxes. IRC §6654(*l*). However, if the trust in question is an administrative trust operating in lieu of a probate estate, and the settlor's will provides for the residue to be poured over to the trust, the trust qualifies for a 2-year exemption from quarterly estimated tax payments. IRC §6654(*l*)(2)(B). See §11.74.

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§13.48 4. Explain Basis Step-Up

Explain to the client the basis step-up for assets. For assets in the trust (or outside the trust, for that matter) that are includable in the decedent's gross estate, other than items that constitute income in respect of a decedent (IRD) (see §14.62), the income tax basis of those assets is increased or decreased to the value determined for federal estate tax purposes (date of death or alternate valuation date). IRC §1014. For transfers from decedents dying after December 31, 2009, there will be an aggregate increase in basis for a surviving spouse of $3 million and $1.3 million for others. IRC §1022. See §§7.26-7.32.

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§13.49 5. Consequences of Funding Gifts

The trustee should understand that:

- The tax consequences of testamentary gifts vary depending on whether the gifts are specific, pecuniary (including a formula), fractional, or residuary. For example, the funding of a specific gift and a fractional gift or residuary gift is not a taxable event, but the funding of a pecuniary gift with assets in kind using date-of-distribution values is a taxable event. See Treas Reg §§1.661(a)-2(f), 1.1014-4(a)(3). See §11.21.
- If distributions are nontaxable, however, the trustee may elect to treat them as taxable, "as if such property had been sold to the distributee at its fair market value." IRC §643(e)(3)(A)(ii).
- When the trustee has made an IRC §645 election for the trust to be taxed as an estate for income tax purposes, a loss may be recognized on the in-kind distribution of depreciated property to satisfy a pecuniary bequest. See §11.50.

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§13.50 6. Trust Income During Administration Period

Discuss the treatment of income earned on trust assets during the postdeath administrative period. If the trust instrument is silent, consult the law of the applicable jurisdiction. In California, the rules are as follows:

- An income beneficiary is entitled to income from the date specified in the trust instrument or, if none is specified, from the date an item of property becomes subject to the trust. When an item of property becomes subject to a trust by reason of a person's death, it becomes subject to the trust as of the person's date of the death, even though there is an intervening period of administration of the person's estate, except that income on the property during the period of administration is governed by Prob C §§12000-12007. Prob C §§16340, 16345.
- Expenses attributable to specifically devised property are first deducted from the income generated by that property. Prob C §12002(b). If the income generated by the asset is not sufficient to pay these expenses, they are paid from the general assets of the trust for the first year after the date of death. Prob C §12002(c). After 1 year, these expenses are a charge against the share of the beneficiary receiving the specifically devised property, and the trustee has an equitable lien on the specifically devised property as against the devisee in the amount paid. Prob C §12002(c).
- A specific gift does not bear interest during the administration period. Prob C §12002(a). However, a specific gift carries with it income on the specifically given property from the date of death, less expenses attributable to the specifically given property during administration of the estate. Prob C §§12002(b), 16340(a)(3).
- If a general pecuniary gift is not distributed within 1 year after the settlor's death, the gift bears interest thereafter. Prob C §§12003, 16340(b).
- Net income received during administration not paid under other provisions of Prob C §§12000-12007 and not otherwise devised shall be distributed pro rata as income among all distributees who receive residuary or intestate property. Prob C §12006.

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§13.51 7. Other Income Tax Issues

Additional income tax issues to be discussed at the first meeting with the client include:

- The difference between simple and complex trusts for income tax purposes. See §11.18. One important consequence of the difference is that trusts classified as simple are deemed to distribute all of their distributable net income (DNI) to the trust beneficiaries whether or not actual distributions of income are made. IRC §652(a). This could result in "phantom" income to the beneficiaries. In a complex trust, in general, distribution of income or principal carries out DNI to the distributees. IRC §662(a).
- Income tax brackets for trusts. See §11.32.
- The timing of distributions to beneficiaries. See §11.16. Consider whether to make distributions of income to lower-bracket beneficiaries during the administrative trust period rather than accumulating income and paying tax at trust level. Distributions within the first 65 days of the trust's tax year may be treated as made on December 31 of the preceding year if an election is made on the trust's fiduciary return. IRC §663(b). Also consider the effect of disproportionate preliminary distributions on allocation of DNI among beneficiaries and income tax effects to the beneficiaries.
- The amount of personal exemption. See §11.31.
- The possibility that the trust will have to issue IRS Form 1099s. If more than $600 is paid to third persons from the trust in any calendar year, the trust must issue a 1099 to payees on or before January 31 following the year in which the payments were made. IRC §6041; Treas Reg §1.6041-1(a); Rev & T C §18631(b), (c)(4).
- Whether the trust instrument either explicitly allows or is silent and therefore allows the trustee to accumulate income. See §14.6.
- The fact that the trust will continue to qualify as an S corporation shareholder for up to 2 years after the decedent's death if certain conditions are met. IRC §1361(c)(2)(A)(ii). See §5.66.
- The fact that the IRC §469(i)(4) special rule for deduction of losses from rental real estate activities in which the decedent actively participated before the decedent's death applies to estates for 2 years, but not to trusts; such losses, therefore, will not be available to the administrative trust, unless the trust can establish material participation in the activity under IRC §469(h). See Temp Treas Reg §1.469-5T; IRS Letter Ruling 200733023; *Mattie K. Carter Trust v U.S.* (ND Tex 2003) 256 F Supp 2d 536.

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L. Discuss Real Property Tax Issues

§13.52 1. Change in Ownership for Property Tax Purposes

In California, property may be reassessed any time there is a change in ownership unless an exclusion applies under Rev & T C §§60-62. When property is transferred to a revocable trust, a change in ownership for property tax purposes does not occur until the death of the settlor. Rev & T C §62(d). In addition, transfers of property between registered domestic partners, including transfers in trust and transfers that take effect at death, do not constitute a change in ownership for purposes of property tax reassessment. Rev & T C §62(p). Note that courts of appeal have split on the question of whether the creation of a life estate on the death of the settlor results in a change in ownership. See *Leckie v County of Orange* (1998) 65 CA4th 334, 76 CR2d 426 (change in ownership). See also *Phelps v Orange County Assessment Appeals Bd. No. 1* (review granted Sept. 9, 2009, S174418; superseded opinion at 175 CA4th 448, 96 CR3d 306); *Reilly v City & County of San Francisco* (2006) 142 CA4th 480, 48 CR3d 291 (change in ownership when sole life income beneficiary dies and is replaced by another sole life income beneficiary). But see *Steinhart v County of Los Angeles* (review granted Dec. 12, 2007, S158007; superseded opinion at 155 CA4th 1082, 66 CR3d 458) (no change in ownership on creation of life estate). Certain transfers of joint tenancy interests in real property to reciprocal trusts benefiting individuals such as siblings and unmarried partners who are not registered domestic partners also may postpone a change of ownership until the death of the surviving settlor, although the State Board of Equalization has proposed amendments to the property tax rules that would eliminate this exclusion. 18 Cal Code Regs §462.040(b)(1).

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§13.53 2. Parent-Child or Grandparent-Grandchild Exclusion

A reassessment of real property in the trust is required at the death of the settlor unless an exclusion applies, such as a parent-child transfer or a grandparent-grandchild transfer when all of the parents of the grandchild who qualify as children of the grandparent are deceased as of the date of transfer. Rev & T C §63.1(a)(3). The exclusion also applies to transfers from a child to a parent (except transfers of property acquired from a foster parent to a biological parent of the foster child) but not to transfers from a grandchild to a grandparent. Parents who qualify as children of the grandparent include spouses of children and former spouses until remarriage. Rev & T C §63.1(c). However, if the parent is a son-in-law or daughter-in-law of the grandparent and a stepparent (but not an adoptive parent) of the grandchild, that parent need not be deceased on the date of the transfer. Rev & T C §63.1(a)(3).

The parent-child exclusion must be claimed within 3 years after the transfer and before transfer of the property to a third party, or within 6 months after notice of a supplemental or escape assessment. Rev & T C §63.1(e)(1). However, the exclusion may be applied prospectively even if the claim is filed late if the property has not been transferred to a third party. Rev & T C §63.1(e)(2). For purposes of Rev & T C §63.1(e)(2), a transfer to a transferor's parent or child is not considered a transfer to a third party. Rev & T C §63.1(e)(4).

If the assessor notifies the transferee in writing of potential eligibility for the exclusion, a certified claim of exclusion must be filed within 60 days of a second notice of potential eligibility that may be sent by the assessor if a certified claim is not filed within 45 days of the first notice. If the claim is not filed within the 60-day period and an eligible transferee later files a claim and qualifies for the exclusion, the assessor may require the transferee to pay a one-time processing fee of not more than $175. Rev & T C §63.1(j).

The parent-child exclusion is limited to the first $1 million of property value (assessed value, not fair market value), plus the settlor's principal residence, which is also exempt. Rev & T C §63.1(a). "Principal residence" includes only the portion of land underlying the principal residence that consists of an area of reasonable size used as a site for the residence. Rev & T C §63.1(b)(1). Therefore, a farm or ranch may not qualify under the principal residence exemption and may require the application of some or all of the $1 million exemption.

PRACTICE TIP: To preserve the full parent-child exclusion and avoid creating undivided interests (when undivided interests are not otherwise desirable for future estate planning purposes), the trustee may need to encumber the property before distribution. For example, if trust property consisting of $250,000 in cash and an unencumbered residence with a fair market value of $750,000 is to be divided equally between two children, and the trustee mortgages the property for $250,000 and then distributes the encumbered property (with a net value of $500,000) to one child and $500,000 in cash to the other, then 100 percent of the residence will be exempt from reassessment because the distribution of the residence will be treated as a parent-child transfer, provided that the trust instrument does not prohibit the trustee from making nonprorata distributions. See Letter to Assessors No. 91/08. If instead the trustee distributes $250,000 in cash and a one-third interest in the residence (with a value of $250,000) to one child and distributes a two-thirds interest in the residence (with a value of $500,000) to the other and the child receiving the two-thirds interest acquires the remaining one-third interest in the property from the other in exchange for a $250,000 promissory note, then one-third of the property will be reassessed because the child will be treated as receiving one-third of the property from the other child rather than the parent. See Annotation 625.0235 (available on the Board's website at http://www.boe.ca.gov). If the trust instrument allows one child to purchase real property interests from his or her siblings, the interest purchased will not qualify for the parent-child exclusion; the purchase option would override a provision granting the trustee power to make nonprorata distributions of that property. See Annotation 625.0235.010. Note further that a loan from the beneficiary to whom the property is distributed to the trustee would be treated as payment to the other beneficiaries, making the parent-child exclusion inapplicable. Letter to Monterey County Assessor (Aug. 4, 2003), Annotation 625.0235.005. However, it appears that the other beneficiaries may lend money to the trustee to fund the distributions to those beneficiaries and the note may be secured by a deed of trust on the property before it is distributed. The money may in turn be obtained by those beneficiaries from loans secured by other property, and

the payments on the note by the beneficiary receiving the property may be used to repay those loans. While the transaction is fairly elaborate, there may be no other way to avoid reassessment.

The parent-child exclusion applies to outright distributions to children or to a continuing trust, provided the children are the *sole* present beneficiaries of the trust. 18 Cal Code Regs §462.160(b)(1)(A). In a sprinkling trust in which the trustee has authority to make income distributions to decedent's children and grandchildren, the regulation states that the property is subject to a change in ownership, but many local assessors take the position that there would be a change in ownership only to the extent that the trustee actually makes distributions to grandchildren.

A parent-child or grandparent-grandchild claim is timely if filed within 3 years after the date of transfer (or before transfer to a third party, if earlier) or 6 months after the mailing of the notice of supplemental or escape assessment. Rev & T C §63.1(e)(1). If the property has not been transferred to a third party, a claim may be filed after the filing period effective beginning with the assessment year in which the claim is filed. Rev & T C §63.1(e)(2).

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§13.53A 3. Spouse or Domestic Partner Exclusion

For purposes of this chapter, a deceased settlor with a same-sex spouse or California registered domestic partner is considered a single settlor because gifts to the spouse or partner on the settlor's death do not qualify for the federal estate tax marital deduction. However, transfers to a registered domestic partner, including transfers at death and transfers in trust, are excluded from a change in ownership for real property tax purposes under Rev & T C §62(p)(1); *Strong v State Bd. of Equalization* (2007) 155 CA4th 1182, 66 CR3d 657'. Reassessment can be reversed until June 30, 2009, for transfers of property occurring before the January 1, 2006, effective date of the statute. Rev & T C §62(p)(2). Transfers to a spouse are excluded under Rev & T C §63. Like the spousal exclusion (see §14.81B) and unlike the parent-child exclusion (see §13.53), the domestic partner exclusion is unlimited. Registered domestic partners may include same-sex couples or opposite-sex couples in which one or both partners are over age 62. Fam C §297.

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§13.53B 4. Joint Tenancy Transfer in Trust

Single settlors wishing to benefit relatives other than children (see §13.53) or partners other than registered domestic partners (see §13.53A) may be able to transfer real property without reassessment to the relative or partner at death by creating a joint tenancy with that person and transferring the joint tenancy interest to a revocable trust. The creation or transfer of a joint tenancy interest, including the transfer to a trust under 18 Cal Code Regs §462.040, is not a change of ownership if after the creation or transfer of the joint tenancy interest the transferor is among the joint tenants. Rev & T C §65(b).

EXAMPLE: *A* and *B*, unrelated parties, own property as tenants in common and transfer the property to themselves as joint tenants. *A* and *B* are "original transferors." *A* and *B* transfer their joint tenancy interests to their respective trusts. *A*'s trust leaves the property to *B*; *B*'s trust leaves the property to *A*. *A* and *B* are still considered to be "original transferors." Result: No change in ownership if either *A* or *B* predeceases the other. The result is the same if *A* first transfers the property to *A* and *B* as joint tenants. See 18 Cal Code Regs §462.040(b)(1); Letter to Assessors 2003/077 (Dec. 18, 2003); Letter to Assessors 2004/042 (July 6, 2004). For further discussion of joint tenancy transfers, see California Estate Planning §15.10 (Cal CEB 2002).

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§13.54 M. Discuss Trustee Compensation and Time Records

The trust instrument may provide a method of determining trustee compensation. If the instrument is silent, a trustee is entitled to "reasonable compensation." Prob C §15681. The trustee is not required to accept a fee, but if he or she does so, the fee must be reported as taxable income. Whether or not the trustee accepts a fee, he or she should keep a log or diary of the work done as trustee, including the date, amount of time expended, description of activity, decisions made, and the basis for the decisions. The log will support the trustee's request for fees in the event of a dispute with the beneficiaries and will also serve as a written record of the trustee's actions and basis for decisions should his or her actions ever be questioned by a beneficiary. See §13.93.

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N. Discuss Attorney Fees and Costs

§13.55 1. Discuss Fees and Billings With Client

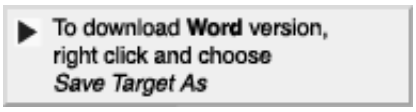
Discuss fees and billings with the client. The author suggests the use of flat fees for postdeath trust administration services whenever feasible. The fixed fee encompasses routine services, including the preparation of any estate tax returns, but may include exceptions for litigation, audits, and so forth. In the author's experience, clients prefer fixed fees to hourly rates. A flat fee creates more certainty for the client and promotes efficiency within the law office. It can, however, leave the practitioner exposed to potential loss for underestimating the amount of time necessary to administer the trust. One solution is to exclude certain types of procedures that would increase the time required for administration; another is to use a hybrid fee agreement.

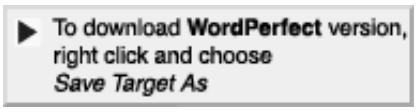
PRACTICE TIP: In a hybrid fee agreement, the client is charged an initial flat fee, and, after the attorney has spent a certain number of hours on the case, the client is charged an hourly fee for additional work. For example, a hybrid agreement might specify a flat fee of $5000 for a trust administration, but also specify that, if the practitioner's hourly time exceeds $7500, the client will be charged the hourly rate for any excess time. In essence, the client receives free any work done between the $5000 and the $7500 fee amounts, but the practitioner is protected from any extraordinary extra work unanticipated at the time the fee was quoted to the client. For sample form, see §13.56.

It is advisable to obtain a signed fee agreement in every case, whether or not required. See Bus & P C §6148. See also §§9.34-9.35.

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§13.56 2. Form: Hybrid Fee Agreement Provision





You may agree to hire us on a "hybrid" fixed fee basis, which will be charged as follows:

You will be charged a minimum fixed fee of $_ _[*dollar amount*]_ _, payable one-half in advance and one-half on "completion," which for the purpose of this Agreement is deemed to be the distribution of the trust under the terms of the trust

[*If applicable, add the following option*]

or the preparation of the federal estate tax return (IRS Form 706), whichever is later.

[*Continue*]

One-quarter of the minimum fixed fee is a nonrefundable fee that is deemed earned on receipt.

In addition, we will calculate and apply hourly fees toward the fixed minimum fee, with billing statements to be generated only internally for our purposes. During this time, we will also be entitled to transfer funds from the client trust account to the firm's general business account on the basis of work completed to date of each interim internal billing, provided, however, that we will receipt one-quarter of the minimum fee on receipt of the initial payment toward the minimum fee. In the event our hourly fees exceed a maximum fee of $_ _[*dollar amount*]_ _, we will bill you on an hourly basis, with no maximum. Before this matter is converted from a fixed-fee basis to an hourly basis, a complete billing statement will be provided for your review. From the point of transition from fixed-fee to hourly billing, we will submit monthly billing statements to you reflecting the work performed and charges made during the billing period involved.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.57 O. Schedule Next Meeting

§13.57 O. Schedule Next Meeting

Schedule a follow-up meeting at the end of the first meeting with the client. Scheduling a second meeting preserves momentum and prevents trust administration files from languishing, particularly when they are not subject to the pressures of statutory and court deadlines.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ V. STEP THREE: IMMEDIATE ACTIONS FOLLOWING FIRST MEETING/§13.58 A. Create Case Management Files and Prepare Agreements

V. STEP THREE: IMMEDIATE ACTIONS FOLLOWING FIRST MEETING

§13.58 A. Create Case Management Files and Prepare Agreements

Office support staff should set up new trust administration files. A suggested method of organizing case files is as follows:

- Folder A: Correspondence and phone notes
- Folder B: Trust administration documents
- Folder C: Assets and liabilities
- Folder D: Research, notes, and memorandums
- Folder E: Taxes
- Folder F: Accounting

In addition to creating new client files for trust administration, prepare and mail the fee agreement to the client if it was not signed at the first meeting.

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§13.59 B. Calendar Critical Dates

As part of the initial case set-up, calendar the dates of these critical actions in the trust administration:

- Lodge pourover will with county clerk (30 days from date of death) (see §13.60);
- Send notification of trust to beneficiaries (60 days from date of death) (see §13.65);
- Disclaimer deadline (9 months from death) (see §13.39);
- File IRS Form 706 (federal estate tax return) and Form ET-1 (state estate tax return) (9 months from death) (see §§12.11, 12.67);
- Date of IRS Form 706 extension, if any (see §12.12);
- Alternate valuation date (6 months from date of death) (see §13.35);
- File IRS Form 709 (gift tax return) (see 1-2 California Decedent Estate Practice §§10.49, 15.15 (Cal CEB 1986));
- File decedent's final personal income tax returns (see 2 Decedent Estate Prac, chap 14);
- File fiduciary income tax returns (15th day of fourth month following fiscal year end) (see §11.42);
- File Preliminary Change of Ownership Report (150 days from death) (see §13.63);
- Make property tax installment payments (December 10; April 10);
- Survival requirements under trust instrument;
- 65-day distribution election (see §11.40);
- Partnership basis election (date partnership return due) (see IRC §754);
- Federal/state payroll tax reporting;
- QSST or ESBT election for S corporation stock (2 months and 15 days from transfer) (see §13.14);
- Medi-Cal notice (90 days from date of death) (see §13.61);
- Prob C §13100 affidavit waiting period (40 days from date of death);
- Option, escrow, or buy-sell dates;
- First trust accounting due (1 year from date of death) (see §13.33);
- Statute(s) of limitations on cause(s) of action of decedent;
- Creditor claim period (if opting in) (4 months from first publication of notice to creditors) (see chap 10; §13.30);
- Statute of limitations on claims against decedent (1 year from date of death) (see chap 10; §13.30);
- Last day to contest trust (120 days from date Prob C §16061.7 notice is received, or up to 60 days later if trust copy not sent originally) (see California Trust and Probate Litigation, chap 20 (Cal CEB 1999));
- Deadline for noncitizen spouse to transfer or irrevocably assign assets to QDOT (due date for filing Form 706, including extensions) (see chap 16);
- Deadline for noncitizen spouse to become citizen, if not creating QDOT (due date for filing Form 706, including extensions) (see chap 16);
- Beneficiaries take decedent's minimum required distribution if decedent has passed RBD (12/31 in the year of decedent's death);
- Determine beneficiaries of retirement plan or IRA (9/30 in year after year of decedent's death);
- Deadline for dividing retirement plan or IRA into separate accounts (12/31 in the year after year of decedent's death); and
- If trust is named as beneficiary of retirement plan or IRA, send list of trust beneficiaries and a copy of the actual trust instrument to plan administrator or fiduciary (10/31 in year after year of decedent's death) (see California Estate Planning, chap 21 (Cal CEB 2002)).

PRACTICE TIP: A document assembly system for trust administration may be purchased or created that includes a program to automatically calendar most of the dates listed above once the date of death is entered.

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§13.60 C. Lodge Pourover Will With County Clerk

The custodian of the decedent's original will must (1) lodge the original will with the clerk of the county where the decedent resided at the time of death and (2) mail a copy of the will to the named executor within 30 days of learning of the death. Prob C §8200. This rule applies even if no probate is required. A certified copy of the will is needed as an attachment to IRS Form 706.

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D. Prepare Letters, Notices, and Forms

§13.61 1. Medi-Cal Notice and Other Notices

A Medi-Cal notice must be sent to the California Department of Health Services within 90 days from the date of death when the decedent received or may have received Medi-Cal health care benefits or was the surviving spouse of a person who received benefits. Giving the notice is the responsibility of the "estate attorney" or, if none, the "beneficiary, the personal representative, or the person in possession of property of the decedent"," and must include a copy of the decedent's death certificate. Prob C §215. Notice also must be sent to the Director of the California Victim Compensation and Government Claims Board within 90 days when the decedent has an heir who is incarcerated. Prob C §§216, 9202. See §10A.30.

If a probate proceeding is initiated, notice of administration of the estate must be sent to the Franchise Tax Board within 90 days after the date letters are first issued to a general personal representative. Prob C §9202. See §10A.31. These notices should be sent by certified mail to avoid a later claim that they were not sent. See, *e.g., Shewry v Wooten* (2009) 172 CA4th 741, 91 CR3d 199 (Medi-Cal notice).

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§13.62 2. Certification of Trust and Affidavit of Death

The certification of trust and affidavit of death of trustee contains an abstract of the trust summarizing the trust provisions, including the identity of the trustee and the trustee powers. For sample forms, see §§13.62A-13.62B. The certification must be recorded in each county where the decedent owned real property. The contents of the certification are prescribed by Prob C §18100.5. Consult local rules for peculiarities of format. Arrange for the client to sign the certification before a notary. In addition, prepare any certifications of trust for ongoing trusts for beneficiaries.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.62A a. Form: Certification of Trust

§13.62A a. Form: Certification of Trust

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CERTIFICATION OF TRUST
THE _ _[*name*]_ _ TRUST

I, _ _[*name of successor trustee*]_ _, hereby declare under penalty of perjury under the laws of the State of California and certify that:

1. On _ _[*date*]_ _, _ _[*name of settlor*]_ _, as settlor, signed a Declaration of Trust which established a revocable trust known as THE _ _[*name*]_ _ TRUST.

2. _ _[*Name of settlor*]_ _ died on October 1, 2009, and _ _[*name of successor trustee*]_ _ is the sole currently acting Trustee of The _ _[*name*]_ _ TRUST.

3. This Certificate is a true and correct representation of the terms of the Trust acting as an administrative trust.

4. The Trust is not of record in any court of law and has not been recorded in the real property records of any county.

5. The Trust has not been revoked, modified, or amended in any manner that would cause the representations contained herein to be incorrect.

6. The current _ _[*beneficiary/beneficiaries*]_ _ of the Trust _ _[*is/are*]_ _ _ _[*name(s)*]_ _.

7. Title to assets of the Trust should be taken in substantially the following form:

_ _[*Name of successor trustee*]_ _ , as Trustee of
THE _ _[*name*]_ _ TRUST
Tax Identification Number: _ _[*last four digits of TIN*]_ _

8. The trust holds the following interest(s) in real property: _ _[*legal description of interest(s)*]_ _.

9. Under the terms of the Trust, the Trustee's powers include the powers set forth in Exhibit A attached hereto and incorporated herein by reference. The Trustee's powers also include all other powers and authority granted to trustees under the California Probate Code, as amended from time to time.

10. This Certificate is intended to serve as a "Certification of Trust" under California Probate Code §18100.5, as amended. Its purpose is to certify the existence of the trust, the identity and powers of the Trustee, the manner of taking title to assets, and to summarize some of the more important provisions of the Trust so that the Trustee can deal with third parties, such as financial institutions, stock transfer agents, brokerage houses, title companies, insurance companies, and others, without disclosing the entire Trust, which is a private and confidential document.

11. All third parties dealing with the Trustee may rely on this Certificate as a true statement of the provisions of the Trust described herein as of the date this Certificate is presented to such third party (regardless of the date of execution of this Certificate), unless the third party has actual knowledge that the representations contained herein are incorrect. The Trustee is expressly authorized to sue a third party who fails to rely on this Certificate and demand damages, including punitive damages, on behalf of the Settlor for such nonreliance.

Executed at _ _[*city*]_ _ , California, on _ _[*date*]_ _.

_____

_ _[*Name*]_ _ , as Trustee of The _ _[*name*]_ _ TRUST, under Declaration of Trust dated _ _[*date*]_ _

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF NAPA)
)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name of trustee*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

EXHIBIT A

Trustee Powers

[*Attach Exhibit A listing Trustee Powers*]

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.62B b. Form: Affidavit of Death of Trustee

§13.62B b. Form: Affidavit of Death of Trustee

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RECORDING REQUESTED BY
AND WHEN RECORDED MAIL TO:

_ _[*Name*]_ _
_ _[*Address*]_ _

MAIL TAX STATEMENTS TO:

_ _[*Name of client*]_ _
_ _[*Address*]_ _

_____
ABOVE THIS LINE FOR RECORDER'S USE ONLY

AFFIDAVIT OF DEATH OF TRUSTEE

STATE OF CALIFORNIA, County of _ _[*name*]_ _ :

_ _[*Name*]_ _ of legal age, being duly sworn, says:

On _ _[*date*]_ _, _ _[*name*]_ _, as settlor, by a Trust Declaration created The _ _[*name*]_ _ Trust;

On _ _[*date*]_ _, the said settlor executed a Grant Deed, recorded _ _[*date*]_ _ in Volume _ _[*number*]_ _ Page _ _[*number*]_ _ in Official Records in the office of the _ _[*name of county*]_ _ County Recorder, conveying to _ _[*name*]_ , as Trustee of the said Trust, the hereinafter described real property;

On _ _[*date*]_ _, _ _[*name*]_ _, the said Trustee, the same person as the decedent mentioned in the certified copy of Certificate of Death, attached hereto as Exhibit A, died;

The said Trust Declaration provides that _ _[*name*]_ _ thereupon became the Trustee of the said Trust, and having accepted the office of Trustee, is now qualified and acting Trustee of the said Trust;

The property hereinabove mentioned, commonly known as _ _[*address*]_ _, is described as follows:

LEGAL DESCRIPTION

A.P.N. _____

Dated: _ _[*date*]_ _

_____
_ _[*Name*]_ _, as Trustee of The _ _[*name*]_ _ Trust, under Declaration of Trust dated _ _[*date*]_ _

STATE OF CALIFORNIA)
COUNTY OF _ _[*name*]_ _) ss
)

Subscribed and sworn to (or affirmed) before me on this _ _[*number*]_ _ day of _ _[*month*]_ _, 20_ _, by _ _[*name of trustee*]_ _, proved to me on the basis of satisfactory evidence to be the person who appeared

before me.

__[*Signature of officer*]__ [*Officer's seal*]

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§13.63 3. Forms for County Assessor's Office

A Preliminary Change of Ownership Report (PCOR) must be filed with the county assessor of each county where the decedent owned real property. The form must be filed even in nonprobate transfers, "including a transfer through the medium of a trust," within 150 days of death. Rev & T C §480(b).

NOTE: Even though not required immediately, it is practical to prepare the application for the parent-child exclusion or the grandparent-grandchild exclusion from reassessment at the same time that the PCOR is prepared and to begin the process of obtaining the signatures of all child or grandchild beneficiaries. See §13.53.

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§13.64 4. Asset and Liability Information

Following the first meeting, the practitioner and the client should continue asset and asset information collection efforts. Sections 13.96-13.104 contain examples of forms useful for collecting the necessary information. The forms provide a way to track whether the appropriate steps have been completed and to gather all the information necessary to prepare IRS Form 706. For a useful asset collection checklist, see Handling Postmortem Trust Administration: A Checklist (Cal CEB Action Guide September 2007).

As part of the continuing asset collection process, the practitioner should request the necessary information from financial institutions. Prepare and send:

- Letters to banks, savings and loans, mortgage companies, brokers, and mutual fund companies requesting cash account balances; date-of-death values of stocks, bonds, and mutual funds; and loan balances on all secured and unsecured loans.
- Letters of instructions to brokers requesting that brokerage accounts be transferred into the name of the successor trustee. Enclose a copy of the death certificate, certification of trust, and taxpayer identification number (TIN) for the administrative trust. Request the date-of-death values for all assets held by the broker.

NOTE: For securities, but not mutual funds, be sure to obtain the mean value of high and low values.

- Letters to insurance companies requesting claims forms and an IRS Form 712 for each insurance policy in which the decedent had incidents of ownership, including policies on lives of persons other than the decedent. Also request information on any annuities.
- Letters to employers, plan administrators, and IRA sponsors concerning retirement benefits. Request copies of beneficiary designations on file, claims forms, and copies of plan documents to analyze beneficiary options.

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§13.65 5. Notification Letter and Attorney Letter to Beneficiaries and Heirs

Send notification to beneficiaries and heirs containing the information required under Prob C §16061.7(g)-(h). See §§2.22-2.27. The notification signed by the trustee may be accompanied by a cover letter from the attorney that should include a statement of nonrepresentation informing the beneficiaries that the attorney does not represent them and that they should seek independent counsel. Consider whether to include contingent beneficiaries. See §13.95.

For a discussion of the trustee's duty to furnish information and keep beneficiaries informed, see §§2.20, 7.1, 13.33.

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§13.66 6. CPA Designation Form and Letter

Send the client a form designating a certified public accountant (CPA) and authorizing communications between the practitioner's law office and the CPA. See §13.105.

When the client returns the signed authorization, mail it to the CPA with a letter describing the terms of the trust, confirming the allocation of responsibility for tax and accounting work, and discussing any related issues. See §13.106.

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§13.67 7. Preliminary Inventory

From information gathered at the first client meeting, prepare a preliminary inventory of the trust estate and mail it to the client with a list of sample assets. Request that the client review the preliminary inventory and make any necessary additions and corrections. See §13.107.

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§13.67A 8. Cancel Credit Cards and Notify Credit Reporting Agencies

All of the decedent's credit cards must be cancelled. Mutilate the cards and return them to the issuers promptly with a statement of the date of death. Similar notices should be sent to traders and business firms from which the decedent made purchases on credit. When such a notice is sent, it is advisable to enclose an extra copy and ask that receipt of the notice be acknowledged by signing and returning the copy.

The three national credit reporting agencies (Equifax, Experian, and TransUnion) should be contacted to close the decedent's credit profile.

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VI. STEP FOUR: FURTHER ACTIONS FOLLOWING FIRST MEETING

§13.68 A. Verify Title to Real Property

Verify title to real property held by the decedent by contacting a title company and ordering copies of the last recorded deed to the property. Identify gaps in title, incorrect legal descriptions, or other problems. If the property is not vested in the name of the trustee, consider alternative steps such as probate or summary administration.

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§13.69 B. Obtain Appraisals

Consider obtaining formal written appraisals for the following items:

- **Real property.** Contact an appraiser and order appraisals of all parcels of real property. Consider the need for a separate discount appraisal if the decedent owned a fractional interest in property. Send letters confirming the appraisals. See §13.108.
- **Tangible personal property.** Determine whether appraisals are required for items of tangible personal property (*e.g.,* household furniture and personal effects, art, other collections, livestock, farm equipment, boats, airplanes). Consider valuation discounts for large art collections. See *Louisa J. Calder* (1985) 85 TC 713; *Estate of David Smith* (1972) 57 TC 650, aff'd (2d Cir 1975) 510 F2d 479; *Estate of Georgia T. O'Keeffe*, TC Memo 1992-210. Send letters requesting the appraisals.
- **Intangible personal property.** Determine whether appraisals are required for intangibles, such as notes, accounts receivable, judgments, causes of action, royalties, or intellectual property.
- **Business interests.** Determine who will appraise interests in closely held businesses or partnerships. If the decedent had a fractional or minority interest, determine whether a discount appraiser is necessary. Determine whether underlying assets (*e.g.,* real estate, equipment, inventory) need to be appraised.

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§13.70 C. Initiate Trust Claims Procedure

If the trustee has elected to opt in to the trust claims procedure (see §13.30), obtain the filing fee and names and addresses of all secured and unsecured creditors from the client and prepare the notices. File the notices with the court to obtain a case number, arrange for publication of notice, and mail notice to all known or reasonably ascertainable creditors. See chap 10A.

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§13.71 D. Other Actions to Take

In addition to the actions mentioned above, the attorney should do the following before follow-up meetings with the client:

- **Request gift tax returns.** Prepare and mail IRS Form 4506 requesting copies of any gift tax returns filed by the decedent. See §13.38. For a sample letter requesting a copy of gift tax returns, see §13.108A.
- **Deliver stock certificates to broker.** If the decedent held stock certificates for publicly traded companies, consider delivering the certificates to a broker and retitling the certificates in the name of the successor trustee or establishing a brokerage account in the name of successor trustee.
- **Communicate with out-of-state counsel regarding ancillary proceedings.**
- **Prepare trust administration memorandum.** Prepare and send a detailed memorandum describing the terms of the trust; the trustee's fiduciary duties; and the division of labor among the client, the CPA, the attorney, and other professionals involved in the administration. The memorandum can serve as a case plan. See §13.109.
- **Prepare documents to collect nontrust assets.** Prepare the necessary documents (*e.g.,* Prob C §13100 affidavits, insurance claim forms, or retirement benefit forms) to collect nontrust assets that pass into the trust by reason of death. If court proceedings are necessary to collect assets or for other reasons, such as to interpret the trust instrument, prepare the appropriate court petitions and commence proceedings.
- **Prepare and send letters regarding retirement benefits.** Prepare and mail letters to employers, plan administrators, and IRA sponsors concerning retirement benefits. Request copies of beneficiary designations on file, claim forms, and copies of plan documents to be used to analyze beneficiary options.
- **Take necessary actions regarding closely held corporations.** For a closely held corporation, consider the need for election of a new officer or director to replace the decedent. Review the corporate minute book to make sure that the minutes are up to date and to determine whether bylaw amendments are needed. Review the corporate documents for buy-sell agreements, split-dollar agreements, and S corporation status. Consider possible reorganization or liquidation.

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§13.72 VII. STEP FIVE: SUBSEQUENT MEETINGS WITH CLIENT AND ACCOUNTANT

The number of follow-up meetings required after the first meeting with the client depends on the complexity of the case and the sophistication of the client. If the CPA was not present at the first meeting before the client designated and authorized communications with the CPA (see §13.66), contact the CPA and encourage him or her to attend subsequent meetings.

At subsequent meetings with the client, the practitioner should:

- **Verify that a trust checking account was established.** Verify that the client has established a checking account for the trust and understands how to use it. Confirm title to the account, the tax identification number, and the account number. Discuss with the client how checking account information will be communicated to the law office or the CPA for entry into the fiduciary accounting program.
- **Review the client's recordkeeping.** Confirm that the client has established a filing and recordkeeping system and is well organized. It is advisable to have the client give the law office records of all accounts in the trust each month during the administration.
- **Discuss the progress on asset collection and appraisal.** Report to the client on the status of collection of assets and appraisals and coordinate efforts if the client is responsible for any collection or appraisals. Review documentation provided by the client.
- **Discuss possible sale of assets.** See §13.73.
- **Consider preliminary distributions.** See §13.74.

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§13.73 A. Discuss Sales of Assets

The practitioner and the client should discuss whether sales of any assets are authorized, necessary, and advisable in light of the following considerations:

- **Need for liquidity.** Sales of assets may be necessary (*e.g.,* for payment of estate tax, cash bequests, claims, debts, or administrative costs). See §13.110.
- **Preference for cash versus in-kind distributions.** The trustee or the beneficiaries may prefer a sale of assets and distribution of cash rather than distributions of assets in kind, particularly when distributions of fractional interests in real property would result. Note the possible tax consequences of funding pecuniary gifts with assets in kind. See §§11.21, 13.49. Further, note that costs of sale in this situation may not be deductible as administrative expenses under IRC §2053. See *Estate of Millikin v Commissioner* (6th Cir 1997) 125 F3d 339.
- **Trustee's authority to sell.** The trust instrument should be reviewed to make sure that the trustee has the power to sell assets. The settlor may have prohibited the sale of certain assets to keep them in the family.
- **Tax issues.** Tax issues arising from a sale of assets include:
- Fixing the value of an asset for alternate valuation purposes if sold within 6 months of the date of death;
- Acceleration of IRC §6166 deferral;
- IRC §2032A recapture;
- IRC §2057 recapture (applicable even after repeal of the §2057 deduction in 2004);
- Basis adjustment;
- Timing of gain or loss; and
- IRD treatment if the property is subject to the decedent's executory contract. IRC §691.
- **Method of sale.** The sale may require referral to a broker to sell securities, to a real estate broker to sell real estate, to a small business broker to sell a family business, or to an auction house for sale of jewelry, art work, antiques, or collectibles.
- **Conflicts of interest.** If the trustee or a beneficiary wishes to purchase an asset, it may be necessary to petition the court for instructions (see §15.26) or to obtain the consent of all the beneficiaries (see §§5.23-5.24).
- **Petition for court approval.** If the sale terms are unusual, or the asset represents a large percentage of the trust estate value, or the beneficiaries are hostile, consider obtaining court approval of the sale by petitioning for instructions in order to protect the trustee. See §15.26.

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§13.74 B. Consider Preliminary Distributions

The attorney should consider whether preliminary distributions are authorized and advisable based on the following analysis:

- Determine whether any distributions should be made before year end to carry out distributions of net income and to avoid trapping income in the trust and paying income tax at higher brackets. See §§11.19-11.20. Consider the availability of the 65-day election. IRC §663(b). See §11.40. Determine whether distributions will trigger income to the trust, *e.g.,* a distribution of income in respect of a decedent (IRD) assets (see §§14.62-14.65), funding pecuniary bequests with appreciated assets in kind, distribution of installment notes, and nonprorata distribution of assets in kind. See 2 California Decedent Estate Practice, chap 18 (Cal CEB 1986).
- Consider that a preliminary distribution before the 6-month alternate valuation date will fix the value for the distributed asset. See IRC §2032(a). See also §13.35.
- Advise the client that making preliminary distributions to some but not all beneficiaries may result in carrying out trust income to distributees if the entire trust is not distributed within the same taxable year. See 2 Decedent Estate Prac, chap 18.
- Advise the client that distributions cannot be made within 2 years after the date of issuance of the certificate of the settlor's death or entry of a judgment determining the fact of settlor's death (whichever event occurs first) if the trustee has received notice or actual knowledge within 4 months of the date of issuance of the certificate of the settlor's death or entry of a judgment determining the fact of settlor's death (whichever event occurs first) that the settlor's genetic material is available for purposes of posthumous conception (and the trustee has not received written notice that the person designated by the settlor does not intend to use the material for the posthumous conception of a child of the settlor), unless the birth of a child of the settlor conceived after death will not affect the proposed distribution. Fam C §7611(f); Prob C §§249.5-249.8. See §14.80.
- If any preliminary distributions will be made, be sure the assets retained are sufficient to pay taxes, expenses of administration, and creditors. If there are potential challenges to the validity of the trust or if distribution provisions are ambiguous, consider deferring all distributions and petition the court for instructions.

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VIII. STEP SIX: PREPARE FOR FINAL DISTRIBUTION

§13.75 A. Finalize Fiduciary Accounting Schedules, Prepare Report and Account

Obtain accounting data from the client and enter it into the fiduciary accounting program. Update and finalize the accounting schedules, or obtain them from the CPA. This should be done regardless of whether a formal account and report are to be made, because the information is critical in allocating receipts and disbursements during the trust administration period.

Draft a formal account and report, when accounting is required or when it is being given to the beneficiaries voluntarily. See §§13.32-13.33. If no formal accounting is to be done, obtain signed waivers from the beneficiaries. Prob C §16064.

Consider whether the trustee should, for the trustee's protection, seek court settlement of the trustee's account and report; if so, file a petition for approval of the account. See chap 7 for full discussion of reporting and accounting and sample forms.

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§13.76 B. Finalize Tax Returns

Funeral expenses must be deducted on IRS Form 706, but there are options regarding where to take other expenses. See IRC §2053(a). Accordingly, decide whether to deduct administration expenses and expenses of the decedent's last illness on IRS Form 706 or 1041, or partly on each. Coordinate with the CPA where deductions will be taken. See §§14.36-14.43.

Finalize estate tax returns for the CPA and client review. Determine whether elections under IRC §2032A or §6166 are available. Determine whether an IRC §2031(c) conservation easement estate tax exclusion is available. The IRS has ruled that a trust is not allowed an income tax deduction for a contribution of a conservation easement under IRC §642(c), because the contribution is considered a contribution of trust principal and therefore is not made from trust income. Rev Rul 2003-123, 2003-2 Cum Bull 1200. Conversely, a post-death contribution of a conservation easement by the trust will usually qualify for an estate tax exclusion, provided that no person claims an income tax deduction. See IRS Letter Ruling 200418005. Obtain the necessary consents from beneficiaries. See §13.36. File the signed return.

Consider a request for prompt assessment of estate taxes. See §13.111.

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§13.77 C. Considerations Before Selecting Distribution Date

To complete preparation for the final distribution:

- Finalize the collection of assets and determine the nature and extent of assets available to distribute.
- Consider waiting until the IRS closing letter is received or statutes of limitation have run before selecting the allocation date and distributing the assets.
- Consider waiting until 2 years after the settlor's death if the settlor could have a posthumously conceived child. See §13.74.
- Consider income tax issues, such as the timing of final distribution, nonprorata distributions, and satisfaction of pecuniary bequests with appreciated assets.
- Determine whether distributions will be pro rata or non-pro-rata.
- Determine which gifts bear interest. See §13.50.
- Consider retaining a reserve for further administration expenses, contingent liabilities, tax deficiencies, audit of IRS Form 706 or 1041, and challenges to accounting to protect the trustee.
- Determine whether the trustee will take a fee, and determine the appropriate amount. Consider whether to obtain court approval. See §13.54.

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§13.78 D. Actions Following Selection of Distribution Date

After taking the steps outlined in §§13.75-13.77, select the distribution date and:

- Obtain updated values of all assets and liability balances (*e.g.,* a principal reduction in a mortgage) to make date-of-distribution value funding decisions.
- Prepare an asset allocation spreadsheet.
- Prepare a written schedule of assets for ongoing trusts.
- Obtain taxpayer identification numbers for ongoing trusts. See §13.46.
- Prepare certifications of trust for any ongoing trusts. See §13.62.
- Prepare a diagram of distribution. See §13.112.
- Send drafts of the spreadsheets, asset schedules, and distribution diagram to the client and the CPA and obtain their approval.
- Consider review of distribution plan by beneficiaries and execution of agreement about distribution.

NOTE: Be aware that a trustee may not require a beneficiary to relieve the trustee of liability as a condition for making a required distribution. Prob C §16004.5.

- Consider petition for court approval of distribution plan.
- Obtain client's and CPA's approval of distribution plan.
- Prepare and send CPA closing letter. See §13.113.

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§13.79 IX. STEP SEVEN: PREPARE TRANSFER DOCUMENTS FOR FUNDING DISTRIBUTIONS

Prepare transfer documents for funding distributions, including the following, as relevant:

- **Written instructions to trustee regarding bank accounts.** Provide the trustee with a letter or written memorandum on closing bank accounts and opening new accounts in the name of ongoing trusts, if any.
- **Deeds and change of ownership reports.** For real property, prepare deeds and preliminary change of ownership reports. Refer out-of-state property matters to a local attorney.
- **Assumption of mortgages.** Prepare an agreement for each beneficiary regarding assumption of mortgages for each distribution of real property.
- **Assignment of leases.** Prepare assignments of leasehold interests and obtain the landlord's consent, if required.
- **Assignments of notes and deeds of trust.** Prepare and record assignments of deeds of trust when the trust owns notes secured by real property.
- **UCC-2 statements.** Prepare and file UCC-2 change statements with the Secretary of State when the trust owns notes secured by personal property.
- **Stock certificates for closely held corporations.** Cancel old stock certificates and issue new ones for closely held corporations.
- **Assignment of partnership interests.** Review partnership agreements to ensure compliance with transfers of partnership interests, such as approval by other partners, and prepare assignments of partnership interest.
- **Assignments of unsecured promissory notes.** Prepare assignments of unsecured promissory notes, and send letters to the makers of the notes advising them of the assignment and providing the name and address of the new holder for making future payments.
- **Assignments of assets of sole proprietorship.**
- **Assignments of personal property.**
- **Forms to complete transfer of mobilehomes.**
- **Letters regarding stock powers, affidavits of domicile, and letter of instructions for stock transfers.**
- **Letters of instructions to broker to transfer securities accounts.**
- **Letters of instructions to mutual fund companies for transfer of accounts.**
- **Transfer forms for Treasury notes and bonds.**
- **Letter and forms for transferring United States savings bonds.**
- **Transfer documents for cars, boats, and airplanes.**

For specific instructions on preparing different types of transfer documents, see 2 California Decedent Estate Practice, chap 21 (Cal CEB 1986).

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§13.80 X. STEP EIGHT: SEND CLOSING DOCUMENTS

Prepare beneficiary receipts. Send accounting, distribution checks, transfer documents, and the receipts to beneficiaries by certified mail.

Send the client a closing packet and termination of engagement letter (see §13.114) together with a client satisfaction survey form, if desired (see §13.115).

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XI. SINGLE-SETTLOR HYPOTHETICAL AND EXHIBITS BASED ON HYPOTHETICAL

§13.81 A. Single-Settlor Hypothetical

For purposes of illustrating the administrative system described in this chapter, the following facts will be assumed.

Mary Lea Single, who died October 1, 2009, was a 45-year-old divorced mother of two children, Travis and Amy (ages 15 and 18), who resided with her. Mary's boyfriend, Roy L. Page, 29, a minor league ball player, lived with Mary at her home in Napa, California. Mary had an estate with a net worth of $4,255,000, consisting of the following assets:

DESCRIPTION OF ASSETS	NET VALUE
Personal residence worth $900,000 with a mortgage of $100,000	$800,000
Casual Aire double-wide mobilehome (rented to sister)	30,000
Condo at Lake Tahoe in joint tenancy with Roy	300,000
Time-share at the Royal Mayan, Cancun, Mexico	6,000
General partnership interest in commercial building	965,000
Sole proprietorship (beauty salon)	98,000
IRA account No. 100-0003 with Vintage Bank	25,000
Brokerage account No. EJC 98-7654 with Edward Jones & Co.	858,000
544 shares of AT&T stock	29,000
348 shares of Anheuser Busch stock	15,000
343 shares of Bank of America stock	5,000
Treasury Note	150,000
Secured Note	15,000
Unsecured Note	15,000
Totten trust account No. 100-0001 at Vintage Bank (payable to sister)	15,000
CD at Vintage Bank, account No. 100-0002	99,000
Checking account No. 100-0004 at Vintage Bank	5,000
Life insurance policy No. NYL1234 with New York Life (face value)	750,000
Tax-deferred annuity contract No. 246810 with Allstate Insurance	25,000
Lincoln Town Car	20,000
Coin collection	5,000
Membership at Napa Valley Country Club	15,000
Household furniture and furnishings	10,000

Mary's revocable trust provides for distribution of her tangible household property to her children, Travis and Amy, in equal shares, when they reach age 35. It also provides for a cash gift of $100,000 to Roy and a gift of the mobilehome to her sister, Sue N. Curtis. The balance is to be divided equally between her children, each share to be held in trust until each child reaches age 35. Mary named her sister, Sue, and Roy as successor cotrustees. Sue is to be sole trustee of the children's trusts to be formed for Travis and Amy.

The 343 shares of Bank of America stock were sold during administration and the proceeds were used to purchase 30 shares of Exxon for $4000. The remaining $1000 was deposited into the checking account.

The CD at Vintage Bank and the Lincoln Town Car were in Mary's name alone, held outside the trust, but neither was listed on Schedule A of the trust. The sole proprietorship beauty salon was listed on Schedule A but was not formally transferred to the trust.

The administration expenses totaled $50,000, resulting in a taxable estate of $4,205,000. The trustees used a portion of the New York Life insurance policy proceeds to pay these expenses and the remaining funds were deposited into the checking account.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ B. Exhibits/§13.82 1. Client Information Tracking Sheet

B. Exhibits

§13.82 1. Client Information Tracking Sheet

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NEW TRUST ADMIN/PROBATE MATTERS
CLIENT INFORMATION TRACKING SHEET

Client:

Office: _ _[*e.g., Fairfield/Napa/Vacaville client*]_ _

Address:

Relationship to Decedent:

Phone #:

FAX #: **E-mail Address:**

DECEDENT'S NAME: **DATE OF DEATH:**

Place of Death: **Decedent's Residence (City):**

[ ] Single Person [ ] Married Person or Domestic Partner

[ ] Testate [ ] Intestate

Estate plan prepared by:

Type of Case: [ ] Probate [ ] Trustad [ ] Conservatorship [ ] Spousal Transfer

ACCOUNTING: [ ] Yes [ ] Need Records [ ] No Records or Accounting Needed

COORD ATTY: _ _[*name*]_ _

PARALEGAL ASSIGNED:

DATE OF 1ST CLIENT MTG: _ _[*date*]_ _ **Office** _ _[*e.g., Napa/Fairfield/Vacaville*]_ _

NOTES: _____

_____

	Date Completed	Initials
I. TRUSTAD SECRETARY		
Fill out trustad info (above) & conflict checksheet	_____	_____
Send client list of documents to bring to first meeting	_____	_____
Enter info into DB as new & start conflict check in ESP DB	_____	_____
Forward conflict check to calendar clerk to complete check	_____	_____

Obtain old ESP file (if possible)	_____	_____
Collect start documents [ ] Single [ ] Married Person	_____	_____
Secretary gives to paralegal to complete start documents	_____	_____
II. COORDINATING ATTY		
Initial meeting with client	_____	_____
Assign responsible paralegal	_____	_____
Communicate fee agreement	_____	_____
III. RESPONSIBLE PARALEGAL		
Draft fee agreement engagement letter	_____	_____
IV. TRUSTAD SECRETARY		
Enter client info into WP merge doc form (5.1 or 6.1)	_____	_____
Send out asset letters	_____	_____
Set up new file (buckets; subfolders)	_____	_____
V. COORDINATING ATTY		
Approve fee agreement/engagement letter	_____	_____
VI. RESPONSIBLE PARALEGAL		
Mail fee agreement/engagement letter	_____	_____
E-mail secretary & calendar clerk re: fee agreement	_____	_____
VII. TRUSTAD SECRETARY		
Schedule critical dates via DB	_____	_____

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§13.83 2. Form: Letter Confirming Appointment

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[*Letterhead*]

_ _[*Date*]_ _

File No:

_ _[*Name*]_ _

_ _[*Name*]_ _

_ _[*Address*]_ _

Re: Estate of _ _[*name*]_ _

Dear _ _[*name*]_ _ and _ _[*name*]_ _ :

Please accept our condolences on the death of your _ _[*e.g., sister and friend, _ _[name]_ _]_ _. This letter is to confirm your appointment with _ _[*name*]_ _ on _ _[*date*]_ _ at _ _[*time*]_ _.

Enclosed is a list of documents we request you to bring to your initial meeting with _ _[*name*]_ _. These documents will help us to proceed efficiently with the commencement of the administration process.

If you have any questions, please do not hesitate to contact our office.

Date: _ _ _ _ _ _ _ _[*Name of firm*]_ _

By: __[*Signature*]__
_ _[*Typed name*]_ _
Legal Assistant

Enclosure

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§13.84 3. Form: Information and Documents Needed

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INFORMATION AND DOCUMENTS NEEDED

Please bring the following documents to our initial meeting:

1. Originals of all wills and codicils (if estate plan not prepared by our office).

2. Originals of all trusts and amendments established by decedent (if estate plan not prepared by our office).

3. Most recent bank statements for accounts on which decedent's name appears as either sole or co-owner in any capacity and copy of signature card for each account. Copies of monthly statements.

4. All passbooks and savings certificates on which decedent's name appears.

5. Most recent statements for all mutual fund and stock brokerage accounts. Copies of monthly statements.

6. Certified copies of death certificate if available (3 copies).

In addition, the following information and documents will also be needed, but need not be brought to the initial meeting, unless readily available:

1. All IRA and qualified pension benefit documents, including beneficiary designation forms and plan descriptions.

2. Certificates of title ("pink slips") for all automobiles, recreational vehicles, boats, trailers, motorcycles, airplanes, etc., in which decedent had any ownership interest.

3. All life insurance policies and annuity contracts, including beneficiary designation forms.

4. All deeds to real property in which decedent had any interest and copies of any notes or deeds of trust to which such properties are subject.

5. All leases for all real property on which decedent was either the landlord or tenant.

6. Most recent personal income tax return.

7. Copies of all gift, estate, and/or generation-skipping transfer tax returns ever filed by the decedent or decedent's spouse at any time in the past.

8. Most recent financial statements and tax returns for any partnership or other closely held business.

9. Copies of any partnership agreements, buy-sell agreements, and corporate records for any partnership or closely held corporation.

10. A list of tangible personal property items that, individually or as a group or collection, have a fair market value in excess of $3000 (*e.g.,* jewelry, art, antiques, or coin, stamp, book, gun, or wine collections).

11. Copies of all bills for expenses of last illness, such as hospital and doctor bills, and an itemized list of all funeral and related expenses.

12. A list of any known debts, liabilities, pending lawsuits, or other claims of or against decedent.

13. Copies of any trust of which decedent was a trustee or beneficiary at the time of death.

14. A list of all safe deposit boxes on which decedent's name appears, by bank and branch, and an inventory of the contents of each.

15. All deeds of trust, notes, or accounts receivable representing payments owed to decedent.

16. All stock certificates, bonds, or other securities.

17. Any other documents that you believe may be important to our understanding of the decedent's personal and financial affairs.

If you have any questions or if any of this information or documentation is not available by the time set for your appointment, we can discuss this at the time of the appointment. Time is of the essence in these matters, and we would prefer not to delay just because a particular document is not available.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.85 4. Form: Client Conflict Information Request

§13.85 4. Form: Client Conflict Information Request

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CLIENT CONFLICT INFORMATION REQUEST

On the following schedules, please identify your children, relatives, business interests, and beneficiaries other than children and relatives, including friends and charitable organizations, listed in the decedent's estate plan.

For business interests, please list the name of any small business corporation, limited liability company, or partnership in which you have an ownership interest.

Please give the attached schedule to the receptionist on arrival in our office for your appointment. Doing so will allow us to quickly identify any potential conflicts with existing clients.

This preliminary information is required to check for any potential conflicts.

CLIENT FAMILY INFORMATION

You: _____ Your Spouse: _____

Your SSN: _____ Spouse's SSN: _____

Your Father: _____ Spouse's Father: _____

Your Mother: _____ Spouse's Mother: _____

Please identify your children below. Use additional pages if needed.

Full Legal Name of Child	Date of Birth	Child of H/W/B	Current Address	SSN (Optional)

Former Spouse: _____ Spouse's Former Spouse: _____

Your Grandchild: _____ Spouse's Grandchild*: _____

Your Grandchild: _____ Spouse's Grandchild*: _____

Your Grandchild: _____ Spouse's Grandchild*: _____

*If same as Spouse, put "Same."

Please identify the beneficiaries of the decedent's estate on the separate beneficiary list provided to you.

List the name of any small business, corporation, limited liability company, or partnership in which you are a shareholder, member, or partner. Please indicate type of entity.

Name	Entity
_____	_____
_____	_____
_____	_____

List the names of any individuals (other than listed above) with whom you jointly own property and the form of ownership.

Name	Form of Ownership	Relationship
_____	_____	_____
_____	_____	_____

Comment: For a sample form of beneficiary list, see §13.88.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.86 5. Form: Trust Summary: One-Person Trust

§13.86 5. Form: Trust Summary: One-Person Trust

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ESTATE OF _ _[*name*]_ _ **Date of Death:** _ _[*date*]_ _

TRUST SUMMARY ONE-PERSON TRUST

Name of Trust: _ _[*e.g., The Single Family Trust*]_ _

Date of Trust: _ _[*date*]_ _

Dates of Amendments, if any:

Trustee(s) of Family Trust before death:

Successor Trustee(s): (1) _ _[*e.g., if cotrustees, list both names*]_ _**; (2)** _ _[*e.g., either* _ _[*name*]_ _ *or* _ _[*name*]_ _*as sole Trustee if the other cannot or will not act*]_ _**; (3)** _ _[*name*]_ _**; and (4)** _ _[*name*]_ _

SUBTRUSTS			
Name	Type	Trustee	Distribution Terms
_ _[*e.g.,* _ _[*name #1*]_ _]_ _ Single Exempt	IRR	Same as FT (Family Trust)	_ _[*e.g., in trust until 35*]_ _
_ _[*e.g.,* _ _[*name #1*]_ _]_ _ Single Nonexempt	IRR	Same as FT	_ _[*e.g., in trust until 35*]_ _
_ _[*e.g.,* _ _[*name #2*]_ _]_ _ Single Exempt	IRR	Same as FT	_ _[*e.g., in trust until 35*]_ _
_ _[*e.g.,* _ _[*name #2*]_ _]_ _ Single Nonexempt	IRR	Same as FT	_ _[*e.g., in trust until 35*]_ _

Specific Gifts: _ _[*e.g., $100,000 to* _ _[*name*]_ _ *and mobilehome to* _ _[*name*]_ _*; tangible personal property to* _ _[*e.g., children*]_ _]_ _**.**

GST Exempt and Nonexempt Division Required?:

Type of GST Funding Formula:

Pecuniary Exempt/Residuary Nonexempt ___
Date-of-Distribution Value ___

Pecuniary Nonexempt/Residuary Exempt ___
Date-of-Distribution Value ___

Fractional Share ___

Possible Disclaimer? ___

Tax Clause: Page ___

Report and Account Clause: Page ___

"Administrative Trust" Provisions: Page ___

Questionable Funding Issues: _____

COMMENTS

POUROVER WILL

Date of Will: _ _[*date*]_ _

Dates of Codicils: _ _[*date(s)*]_ _

Executor(s): _ _[*name(s)*]_ _

Any Specific Gifts: _ _[*e.g., distribution of tangible personal property to family trust*]_ _

Tax Clause:

Guardian of Person:

(1) _ _[*name*]_ _

(2) _ _[*name*]_ _

(3) _ _[*name*]_ _

(4) _ _[*name*]_ _

COMMENTS

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§13.86A 6. Form: Petition for Determination of Proration of Estate Tax

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GAW VAN MALE
David Gaw
Attorney at Law
State Bar No.:
1000 Main Street, Third Floor
Napa, CA 94558
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Attorneys for Petitioners
SUE N. CURTIS and ROY L. PAGE

SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF NAPA

In re THE SINGLE FAMILY TRUST dated December 16, 2003	)	**Case No.:**
	)	
	)	**PETITION FOR**
	)	**DETERMINATION OF**
	)	**PRORATION OF ESTATE TAX**
		(PROB C §§20120-20125)
		Hearing Date: _ _[*date*]_ _
		Time: _ _[*time*]_ _
		Dep't: _ _[*number*]_ _
		Judge: _ _[*if known*]_ _

SUE N. CURTIS and ROY L. PAGE (Petitioners), as co-trustees of the SINGLE FAMILY TRUST dated December 16, 2003, hereby allege as follows:

1. On December 16, 2003, MARY LEA SINGLE (Decedent) formed a revocable trust known as the SINGLE FAMILY TRUST (the Trust). The Decedent died on October 1, 2009, a resident of Napa County, California. SUE N. CURTIS and ROY L. PAGE became successor Co-Trustees of the Trust. No probate proceedings were commenced on the Decedent's behalf because none of her assets were subject to probate.

2. The Decedent's estate was primarily held in the Trust. The only asset outside of the Trust was an IRA which was payable to JACK P. SINGLE, the Decedent's ex-husband. JACK P. SINGLE is not a beneficiary of the Trust. Decedent's total estate was valued at $4,255,000 as of the date of her death. The IRA was valued at $25,000 as of Decedent's death.

3. Petitioners filed a federal estate tax return for decedent's estate. A copy of the federal return is attached hereto, as Exhibit A and made a part hereof. The federal estate tax was $317,250. The federal estate tax were paid from cash of the Trust in the Petitioners' possession. The total gross estate was $4,255,000. Deductions total $50,000. The taxable estate therefore is $4,205,000. All of the expenses of administration were chargeable to AMY and TRAVIS SINGLE, the residuary beneficiaries of the Trust.

4. Pursuant to Probate Code §§20110 and 20111, in the absence of contrary provisions in a decedent's will or trust, estate taxes are to be equitably prorated among the beneficiaries of an estate in the proportion that the value of the property received by each beneficiary bears to the total value of all property received by all persons interested in the estate.

5. Petitioners contend that the equitable apportionment of the federal estate tax among all persons interested

in decedent's estate in proportion to the value of the property received by each, and after allowance for deductions already described, results in each person's being chargeable with taxes in the following amounts:

Beneficiaries	*Amount Received*	*Percentage of Estate*	*Amount of Estate Tax*
Sue N. Curtis	**$45,000**	**1.0702%**	**$3,395.07**
Roy L. Page	**$400,000**	**9.5125%**	**$30,178.36**
Amy L. Single	**$1,867,500**	**44.4114%**	**$140,895.21**
Travis D. Single	**$1,867,500**	**44.4114%**	**$140,895.21**
Jack P. Single	**$25,000**	**0.5945%**	**$1,886.15**
Total:	**$4,205,000**	**100.0000%**	**$317,250.00**

6. It is necessary for Petitioners to require a determination of the proper apportionment of the estate tax because JACK P. SINGLE, the decedent's ex-spouse, has not responded to Petitioners' request for payment of his share of the estate tax.

WHEREFORE, Petitioners pray that the Court make and enter its Order:

1. Apportioning the estate tax among the persons interested in decedent's estate in the manner and amounts set forth above and authorizing Petitioners to charge the persons against whom an estate tax is prorated the prorated amounts to the extent that Petitioners are in possession of any property or interests of those persons;

2. To require JACK P. SINGLE to pay to Petitioners the amount of estate tax prorated against him; and additionally authorizing Petitioners to do all acts necessary or convenient to carry out the apportionment and payment of the estate tax described above;

3. For such other and further orders as the Court shall deem necessary, proper, or just.

Dated: _ _[*date*]_ _ __[*Signature*]__
David Gaw
Attorney for Petitioners

VERIFICATION

We, the undersigned, have read the foregoing petition and know the contents thereof, we certify that the same is true of our own knowledge, except as to the matters therein stated on information and belief, and as to those matters, we believe them to be true.

We declare under penalty of perjury under the laws of the state of California that the foregoing is true and correct.

Executed on _ _[*date*]_ _**, at** _ _[*city*]_ _**, California.**

__[*Signature*]__
SUE N. CURTIS,
Petitioner

__[*Signature*]__
ROY L. PAGE,
Petitioner

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§13.87 7. Form: Authorization to Disclose Information

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AUTHORIZATION TO DISCLOSE INFORMATION

_ _[*Name*]_ _ and _ _[*name*]_ _, as Cotrustees of _ _[*e.g., the Single Family Trust*]_ _, under Declaration of Trust dated _ _[*date*]_ _, established by _ _[*name*]_ _, deceased ("Decedent"), hereby authorize the following named financial institution or company and its affiliates, agents, and employees ("the Company"):

_____

to disclose to my attorney, _ _[*name*]_ _, and my attorney's agents and employees, any and all account information, including but not limited to account numbers, account balances, accrued interest, transaction histories, loan numbers, insurance policy numbers, and copies of statements, account applications, beneficiary designation forms, signature cards, and any other information within your possession or control, with respect to any account with the Company standing in the name of the undersigned, whether as Trustee or individually, or standing in Decedent's name alone or jointly with others.

The address and telephone number of my attorney are as follows:

_ _[*address*]_ _

_ _[*telephone number*]_ _

I reserve the right to revoke this authorization at any time by written notice to the Company.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _

__[*Signature*]__
_ _[*Typed name*]_ _

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§13.88 8. Form: Beneficiary and Heir List

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THE SINGLE TRUST Beneficiary/Heir List			
Name and Relationship	**Address**	**Phone**	**SSN**

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.89 9. Form: Asset Collection

§13.89 9. Form: Asset Collection

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ASSET COLLECTION SHEET
FOR THE _ _[*name*]_ _ TRUST

Key to Abbreviations:

T: Trust

NT: Nontrust

JT: Joint Tenancy

CP: Community Property

CPR: Community Property with Right of Survivorship

DK: Don't Know

Asset Description	Title/ Funding (circle one (T, NT, etc.) for each asset listed)	Estimated Value	Appraised Value	Distrib. Value
Real Property				
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
Publicly Traded Stocks and Bonds Brokerage Accounts, Savings Bonds, Etc.				
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			

	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
Bank, Savings & Loan, and Credit Union Accounts				
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
Business Interests and Promissory Notes				
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
Insurance on Decedent's Life	Beneficiary			
Annuities, IRAs, and other Retirement				
Miscellaneous Property (including insurance on others, partnerships, tangible personal property, etc.)				
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			

	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
	T - NT - JT - CP - CPR - DK			
Transfers During Decedent's Life (*e.g.,* revocable and irrevocable trusts)				
Powers of Appointment (*e.g.,* 5 or 5 power)				

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§13.90 10. Form: Trust Liabilities

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LIABILITIES FOR THE _ _[*name*]_ _ TRUST

Creditor Name and Address	Secured/ Unsecured	Estimated Amount	Actual Amount
_ _[*e.g., XYZ Loan Co.,* _ _[*address*]_ _]_ _	S	_ _[*e.g., $ 200,000*]_ _	
	S - U		
	S - U		
	S - U		
	S - U		
	S - U		
	S - U		
	S - U		
	S - U		
	S - U		
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	S - U		
	S - U		

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§13.91 11. Form: Instructions Regarding Medical, Funeral, Administration, and Personal Expenses

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INSTRUCTIONS REGARDING MEDICAL, FUNERAL, ADMINISTRATION, AND PERSONAL EXPENSES

For both tax and fiduciary accounting purposes, it is important to accurately track and pay from the proper source certain medical, funeral, and administration expenses.

DECEDENT'S UNPAID MEDICAL EXPENSES (pay from the trust and deduct either on the decedent's final income tax return or on the federal estate tax return)

FUNERAL AND RELATED EXPENSES (pay from the trust and deduct only on the federal estate tax return)

ADMINISTRATION EXPENSES (pay from the trust and deduct either on the trust's income tax returns or on the estate tax return)

PERSONAL EXPENSES (pay individually and not from the trust; not deductible)

For tax-deductible items, when there is a choice, the decision about which return to take the deduction on will be made in cooperation with your CPA or tax preparer. Your assistance in tracking these expenses is vital. To assist you in this process, you will find attached blank forms with instructions for tracking these expenses.

You must also be careful to segregate expenses that are your *personal* expenses or the *personal* expenses of another beneficiary; these should be paid from personal funds, not trust funds.

If the trust does not have sufficient funds on hand to pay medical, funeral, or administration expenses chargeable to the trust—for example, because there were no bank accounts in the name of the trust—you may lend personal funds to the trust or arrange to borrow from another source and repay these loans later from trust funds or through adjustments to asset allocations. You must keep accurate records of such loans and advise us accordingly.

If you do not have sufficient funds to pay your own personal expenses, *do not* use trust funds to pay such expenses without first contacting us. Payment of your personal expenses from trust funds may have unanticipated tax consequences and may violate your fiduciary duties, as well as create internal accounting problems in making final distributions and allocations. To solve this problem, it may be possible to make preliminary distributions of trust funds to beneficiaries, or to the survivor's trust in the case of a married couple, but such distributions should be made after consultation with your attorney.

To ensure proper payment of expenses, open a checking account in your name as trustee of the trust (using the trust's TIN, not your SSN). Pay all trust expenses and deposit all trust receipts exclusively to and from this account. Do not add nontrust funds to this account, such as life insurance proceeds, joint tenancy accounts, IRA distributions, or annuities, payable outside the trust. In the case of a surviving spouse, nontrust funds received by the spouse outside the trust should be transferred immediately to the survivor's trust to avoid probate.

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§13.92 12. Form: Last Illness, Funeral, and Administration Expenses

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EXPENSES OF LAST ILLNESS

List expenses of last illness incurred by the decedent and not reimbursed by insurance, Medicare, etc., (*e.g.,* medicine, hospital, ambulance, and doctor). Add additional pages if needed. As an alternative to listing "To Whom Paid" and/or "Description of Expenses," you may attach a copy of the invoices or statements.

Date	Amount Paid	To Whom Paid	Description of Expenses	Source of Payment (Bank Account No.)

FUNERAL EXPENSES

List below any funeral expenses. Such expenses may include, but are not limited to, the following: funeral and burial ceremony, casket, burial plot for decedent or his or her family, undertaker's fees, flowers, food for mourners, clothing for burial, costs of transportation of person bringing the body to place of burial, tombstone, grave marker, monument or mausoleum, cost of landscaping lot, and, depending on deductibility under state law, perpetual care of cemetery lot or mausoleum.

Date	Amount Paid	To Whom Paid	Description of Expenses	Source of Payment (Bank Account No.)

ADMINISTRATION EXPENSES

List administration expenses incurred during the course of the trust administration. Such expenses may include, but are not limited to, the following: court costs and filing fees, accountant fees, attorney fees, executor fees, notary fees, travel expenses, tax consultants, investment advisor fees, premiums on bonds, and selling costs of selling assets if these sales are necessary to pay taxes, debts, or to effect an orderly distribution. Add additional pages if needed. As an alternative to listing "To Whom Paid" and/or "Description of Expenses," you may attach a copy of the invoices or statements.

Date	Amount Paid	To Whom Paid	Description of Expenses	Source of Payment (Bank Account No.)

ADDITIONAL PAGE

Date	Amount Paid	To Whom Paid	Description of Expenses	Source of Payment (Bank Account No.)

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§13.93 13. Form: Trustee Time Report

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TRUSTEE TIME REPORT		
Date	**Description of Services**	**Time Spent**

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§13.94 14. Form: Environmental Questionnaire

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ENVIRONMENTAL QUESTIONNAIRE FOR COMMERCIAL AND INDUSTRIAL PROPERTIES

Decedent: _ _[*name*]_ _

Name of Proposed Trustee: _ _[*name*]_ _

Subject Property: _ _[*address*]_ _

In connection with the trust administration of the above-named decedent, it is important to collect information concerning the property described above.

Please complete the entire questionnaire carefully. If some of the requested information is not available, please insert "unknown" or "not applicable" as appropriate. If you need more space than is provided to adequately respond to the question, please use the back of the questionnaire or a separate sheet of paper.

1. Property address/location:

2. County assessor's parcel number:

3. Property owner:

4. Size of the property (estimated total acreage and square feet of buildings):

5. Date current operations began on site:

6. What year were any building(s) on site constructed:

7. Does land use surrounding the site currently, or has it in the past, included any of the following (check all applicable categories and indicate the type of activity):

_____ heavy industry **_____ light industry**

_____ landfill/waste disposal **_____ waste treatment**

8. Have any environmental audits been conducted at the site? If so, please attach a copy.

9. The type of activity currently conducted on site is _ _[*specify; provide standard industrial classification (SIC) code, if applicable*]_ _**.**

10. To the extent known, please identify the prior uses of the property and the prior owner(s) of the site during the past 50 years:

DATES	LAND USE	PROPERTY
_____	_____	_____
_____	_____	_____

_____ _____ _____

_____ _____ _____

11. Is there any environmental contamination present or under investigation on site? If so, please attach assessment results or describe:

12. Have any waste materials ever been dumped, buried, or landfilled on site? If so, please describe:

13. Have there been any past pollution problems, investigations, or cleanup actions on site, including investigations of potential Superfund actions? If so, please attach assessment results or describe incident(s) and any cleanup action(s):

14. Have there been any spills, leaks, or accidental releases of chemicals or wastes into the environment? If so, please describe:

15. Are there any past, current, or pending regulatory actions by federal, state, or local environmental agencies alleging noncompliance with regulations? If so, please describe:

16. Are there any past, current, or pending lawsuits or administrative proceedings naming the facility for alleged environmental damages? If so, please describe:

17. Has an underground storage tank leak ever occurred on site? If so, please describe the incident:

18. Have there been any leaks, spills, or fires on site involving PCB electrical equipment?

19. Has the facility applied for or been issued a permit as a Hazardous Waste Generator; Hazardous Waste Treatment, Storage, or Disposal Facility; or a Hazardous Waste Hauler? If so, indicate permit type:

20. Are any of these chemicals used or stored on site? If so, what are the estimated quantities? Either attach a chemical inventory or list the three chemicals in each category used in the greatest quantity, and the annual quantity used.

____Solvents	**____Fuels**	**____Oxidizers**
_____	_____	_____
_____	_____	_____
_____	_____	_____
____Acids	**____Bases**	**____Pesticides**
_____	_____	_____
_____	_____	_____
_____	_____	_____
____Oils	**____Inorganics**	**____Organics**
_____	_____	_____
_____	_____	_____
_____	_____	_____
____Gases	**____Explosives**	**____Radioactive Materials**

_____ _____ _____

_____ _____ _____

_____ _____ _____

____Other (Please Describe)

_____ _____ _____

_____ _____ _____

_____ _____ _____

21. Are any of the following waste types generated or handled on site? Please check all applicable categories and indicate estimated annual quantities:

____ Hazardous Wastes

____ PCBs

____ Industrial Wastewater

____ Air Emissions

____ Waste Oils

____ Sludges

____ Other (Please Describe)

22. Are pollution controls employed or is there monitoring at the site to prevent or minimize the release of chemicals or wastes into the environment? If so, please describe:

23. Are chemicals and wastes currently stored on site, or have they been stored on site in the past? Check all applicable categories of storage methods:

___ Drums **___ Waste Piles**

___ Containers **___ Pits**

___ Above-Ground Tanks **___ Sumps**

___ Surface Impoundments/ Ponds/Lagoons **___ Other (Please Describe)**

Are the chemical and waste storage areas provided with spill containment? If so, please describe:

24. Are there now, or have there ever been, underground storage tanks located on site? If so, indicate the number of tanks, contents, and age:

Have any of the following measures been provided for the underground tanks and their associated piping?

___ Integrity Testing **___ Inventory Reconciliation**

___ Leak Detection System **___ Overfill Spill Protection**

___ Secondary Containment **___ Cathodic Protection**

___ Other (Please Describe)

25. Are any above- or below-ground pipelines on site used to transfer chemicals or waste? If so, please describe.

26. Have the pipelines been inspected or tested for leaks? If so, please indicate results:

27. Are any friable (*i.e.,* brittle or easily crumbled) asbestos-containing materials present in the building on site? If an asbestos test or survey has been conducted, please attach the results.

28. Have there been any worker complaints or regulatory investigations regarding illnesses resulting from hazardous material exposure at the facility? If so, please describe status and any corrective actions taken.

29. Does any of the on-site electrical equipment (*e.g.,* transformers, capacitors) contain PCBs? If so, are there maintenance and emergency response procedures for the PCB equipment in the event of a leak, spill, or fire?

30. Are there any on-site sewage disposal systems (*e.g.,* septic tank, wastewater treatment plant)? If so, have there been any failures of the systems? Please describe:

31. Have any of the following environmental permits, registrations, or agreements been issued to the facility? (Check all applicable categories and attach a copy of the permit(s).)

_____ National Pollutant Discharge Elimination System (NPDES) Permit

_____ Air Emissions Permit

_____ Wastewater Discharge Permit

_____ Underground Storage Tank Permit

_____ Hazardous Materials Monitoring Program Permit

_____ Other (Please Describe)

32. Have there been any citizen complaints from the surrounding community regarding facility operations? If so, please describe:

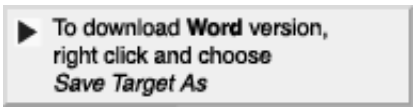
33. Are any environmental hazards or contamination present on surrounding properties (*e.g.,* underground storage tanks, heavy industry, landfills/waste disposal, waste treatment, ground water contamination)? If so, please describe:

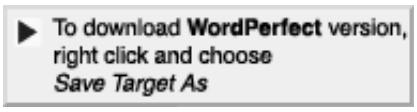
34. Is there any evidence that the hazards identified in question 33 may spread to the subject property?

_ _[*Date*]_ _ __[*Signature*]__
_ _[*Typed name*]_ _

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§13.95 15. Sample Letter to Clients and Notification by Trustee





LAW OFFICES
GAW VAN MALE

_ _[*Date*]_ _

Our File: COURT-1

Amy Lynn Single
Travis Dan Single
921 High Ave.
Napa, California 94558

Re: Estate of Mary Lea Single
The Single Family Trust

Dear Ms. and Mr. Single:

Please accept our condolences on the death of your mother, Mary Lea Single. As part of your mother's estate plan, she established a living trust called The Single Family Trust ("the Trust"). A copy of the Declaration of Trust that established the Trust is enclosed. Also enclosed is a copy of your mother's last Will, as well as the notice required under Probate Code §16061.7. The purpose of this letter is to make you aware of the existence of the Trust and explain briefly the process of trust administration.

The purpose of the Trust was to avoid probate. Probate is a court-supervised procedure for administering a person's property and affairs after death. Probate tends to be slow and expensive. Although trust administration is not without expenses, usually significant savings can be achieved.

Although revocable during lifetime, the Trust became irrevocable as a result of your mother's death. Thus, its terms cannot be amended or changed. Your mother named Sue N. Curtis and Roy L. Page as Cotrustees of the Trust. As Cotrustees, Sue N. Curtis and Roy L. Page have the authority to manage the Trust, make investment decisions, distribute property from the Trust, or otherwise deal with the trust property. The Cotrustees are also responsible for keeping financial records and filing income tax returns for the Trust. As a beneficiary, you will be entitled to information concerning the Trust and its administration. At least annually, the Cotrustees will be required to provide you with an accounting and report of the Trustees' administration.

If there are any assets other than automobiles, furniture, furnishings, and other household personal property that have not already been transferred into the Trust, the will provides that such property will pass to the Trust. If assets outside the Trust exceed $100,000, a probate may be required. Otherwise, no probate will be required.

The Cotrustees are responsible for appraising all of your mother's assets, whether inside or outside the Trust, in preparing the federal estate tax return and paying any taxes. Because the total estate is in excess of _ _[*dollar amount, e.g. $3,500,000 in the year 2009*]_ _, there will be estate taxes. The current estate tax rate is 45 percent. The Cotrustees are also responsible for ensuring that all creditors are paid.

Until the determination regarding debts and taxes has been made, the Cotrustees will continue to operate the Trust as a single entity called The Single Family Trust.

At the expiration of the trust administration, after certain specific distributions, one-half of the remaining assets will be held in trust for each of you until you reach the age of thirty-five (35) years.

Please remember that we represent only the Trustees and not either of you individually. Thus, we cannot give you legal advice concerning your interest as a beneficiary. If you have any questions generally concerning your rights and interests with respect to the Trust, please consult your own attorney.

Very truly yours,

GAW VAN MALE

DAVID B. GAW

cc: Sue N. Curtis
Roy L. Page

NOTIFICATION BY TRUSTEE UNDER
PROBATE CODE SECTION 16061.7

As required by law, you are hereby provided with notice of the following information regarding The SINGLE FAMILY TRUST:

1. The name of the Settlor of the trust is: Mary Lea Single

2. The trust was executed on: December 16, 2003

3. The names, address, and telephone number of the current Trustees are:

Roy L. Page and Sue N. Curtis
165 Stonehenge Drive
Napa, California 94558
(707) 555-4321

The Trustees request that correspondence relating to the trust be directed to their attorneys at the following address:

Roy L. Page and Sue N. Curtis
c/o Gaw Van Male
1000 Main Street, 3rd Floor

Napa, California 94559
Telephone: (707) 252-9000 Fax: (707) 252-0792

4. The principal place of administration of the Trust shall be:

465 Stonehenge Drive
Napa, California 94558

5. You are entitled, as a possible beneficiary or heir at law of the decedent, to request from the trustee a true and complete copy of the "Terms of the Trust," as that term is defined in Probate Code §16060.5. However, in your case, the Trustee has elected to enclose with this Notification a true and complete copy of the entire Trust, including any amendments to it.

<u>WARNING</u>: YOU MAY NOT BRING AN ACTION TO CONTEST THE TRUST MORE THAN 120 DAYS FROM THE DATE THIS NOTIFICATION BY THE TRUSTEE IS SERVED UPON YOU OR 60 DAYS FROM THE DAY ON WHICH A COPY OF THE TERMS OF THE TRUST IS MAILED OR PERSONALLY DELIVERED TO YOU DURING THAT 120-DAY PERIOD, WHICHEVER IS LATER.

Date: _ _ _ _ _ _ __[*Signature*]__
Roy L. Page

Date: _ _ _ _ _ _ __[*Signature*]__

Sue N. Curtis

Comment: The warning must be printed in at least 10-point boldface type. The trustee signatures are optional.

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ 16. Asset Information/§13.96 a. Form: Real Property

16. Asset Information

§13.96 a. Form: Real Property

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REAL PROPERTY

Key to Abbreviations:

T: Trust

NT: Nontrust

JT: Joint Tenancy

CP: Community Property

CPR: Community Property with Right of Survivorship

DK: Don't Know

REAL ESTATE	Title (T, NT, JT, CP, CPR, DK)	Estimated Value	Appraisal Ordered	Date Ordered	Appraisal Value	Alternate Value	Distributed Value
Real Estate 1							
Address							
City							
State							
Accrued Rent Due							
Unearned Rent Payable							
Real Estate 2							
Address							
City							
State							
Accrued Rent Due							

Unearned Rent Payable							
Real Estate 3							
Address							
City							
State							
Accrued Rent Due							
Unearned Rent Payable							

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.97 b. Form: Traded Securities

§13.97 b. Form: Traded Securities

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TRADED SECURITIES
Listed and Over-the-Counter Stocks

Certificate No: _____ Name of Company: _____

Number of Shares: _____ Type of Stock: _____

Estimated value at death: _____

Mean value at death: _____ (If death occurred on Sat., Sun., or holiday, give mean value of trading day before and after death.)

Alternate valuation date value: _____

Date-of-distribution mean value: _____

Principal exchange: _____

If not on exchange, address of company: _____

Dividend declared before valuation date and payable after valuation date: Yes / No

If yes: a) Declaration date: _____

b) Record date: _____

c) Payment date: _____

Certificate No: _____ Name of Company: _____

Number of Shares: _____ Type of Stock: _____

Estimated value at death: _____

Mean value at death: _____ (If death occurred on Sat., Sun., or holiday, give mean value of trading day before and after death.)

Alternate valuation date value: _____

Date-of-distribution mean value: _____

Principal exchange: _____

If not on exchange, address of company: _____

Dividend declared before valuation date and payable after valuation date: Yes / No

If yes: **a) Declaration date: _____**

b) Record date: _____

c) Payment date: _____

Certificate No: _____ **Name of Company: _____**

Number of Shares: _____ **Type of Stock: _____**

Estimated value at death: _____

Mean value at death: _____ (If death occurred on Sat., Sun., or holiday, give mean value of trading day before and after death.)

Alternate valuation date value: _____

Date-of-distribution mean value: _____

Principal exchange: _____

If not on exchange, address of company: _____

Dividend declared before valuation date and payable after valuation date: Yes / No

If yes: **a) Declaration date: _____**

b) Record date: _____

c) Payment date: _____

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§13.98 c. Form: Mutual Funds

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MUTUAL FUNDS

Mutual fund name: _____

Mutual fund no. of shares: _____

Estimated value at death: _____

Actual closing redemption price: _____ (If on Saturday, Sunday, or holiday, give value for first day before death)

_____

Mutual fund name: _____

Mutual fund No. of shares: _____

Estimated value at death: _____

Actual closing redemption price: _____ (If on Sat., Sun., or holiday, give value for first day before death.)

_____

Mutual fund name: _____

Mutual fund no. of shares: _____

Estimated value at death: _____

Actual closing redemption price: _____ (If on Saturday, Sunday, or holiday, value for first day before death)

_____

Mutual fund name: _____

Mutual fund no. of shares: _____

Estimated value at death: _____

Actual closing redemption price: _____ (If on Sat., Sun., or holiday, give value for first day before death.)

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§13.99 d. Form: U.S. Bonds

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U.S. BONDS

U.S. Savings Bond (EEE or HH): _____

Estimated redemption value at death: _____

Redemption value at death: _____

Alternate value at death: _____

Distribution value at death: _____

_____

U.S. Savings Bond (EEE or HH): _____

Estimated redemption value at death: _____

Redemption value at death: _____

Alternate value at death: _____

Distribution value at death: _____

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§13.100 e. Form: Other Securities

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OTHER SECURITIES

Name of company: _____

No. of shares: _____

Street address of principal office: _____

City: _____ State: _____

Estimated value at death: _____

Appraised value at death: _____

Alternate value at death: _____

Date-of-distribution value at death: _____

_____

Name of company: _____

No. of shares: _____

Street address of principal office: _____

City: _____ State: _____

Estimated value at death: _____

Appraised value at death: _____

Alternate value at death: _____

Date-of-distribution value at death: _____

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§13.101 f. Form: Bank, Savings and Loan, and Credit Union Accounts

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BANK, SAVINGS & LOAN, AND CREDIT UNION ACCOUNTS

Name of financial institution: _____

Address of financial institution: _____

City: _____ State: _____

Estimated value at death: _____

Actual value at death: _____

Accrued interest to date of death: _____

Distribution value: _____

Account no.: _____

Type of account: _____
(savings, checking, time deposit, etc.)

_____

Name of financial institution: _____

Address of financial institution: _____

City: _____ State: _____

Estimated value at death: _____

Actual value at death: _____

Accrued interest to date of death: _____

Distribution value: _____

Account no.: _____

Type of account: _____
(savings, checking, time deposit, etc.)

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.102 g. Form: Life Insurance

§13.102 g. Form: Life Insurance

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LIFE INSURANCE

Name of life insurance company: _____

Policy no.: _____

Beneficiary name: _____

Estimated proceeds: _____

Actual proceeds received: _____

_____

Name of life insurance company: _____

Policy no.: _____

Beneficiary name: _____

Estimated proceeds: _____

Actual proceeds received: _____

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.103 h. Form: Annuities, IRAs, and Retirement Benefits

§13.103 h. Form: Annuities, IRAs, and Retirement Benefits

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ANNUITIES, IRAs, AND RETIREMENT BENEFITS

IRAs:

Name of institution for IRA: _____

Address of Plan Administrator: _____

City: _____ **State:** _____

Account no.: _____

Beneficiary: _____

Estimated value at death: _____

Actual value at death: _____

_____

Name of institution for IRA: _____

Address: _____

City: _____ **State:** _____

Account no.: _____

Beneficiary: _____

Estimated value at death: _____

Actual value at death: _____

_____

Annuities:

Name of annuity company: _____

Address: _____

City: _____ **State:** _____

Contract no.: _____

Beneficiary: _____

Estimated value at death: _____

Actual value at death: _____

_____

Retirement

Name of retirement plan: _____

City: _____ State: _____

Account no.: _____

Beneficiary: _____

Estimated value at death: _____

Actual value at death: _____

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.104 i. Form: Promissory Notes, Mortgages, and Deeds of Trust

§13.104 i. Form: Promissory Notes, Mortgages, and Deeds of Trust

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PROMISSORY NOTES, MORTGAGES, AND DEEDS OF TRUST

Promissory note: _____

Date of note: _____

Date of maturity of note: _____

Rate of interest: _____

Name of maker: _____

1st, 2nd, or 3rd deed of trust of note: _____

Address of collateral: _____

City: _____ State: _____

Estimated unpaid balance at date of death: _____

Unpaid balance at death on note: _____

Accrued interest to date of death on note: _____

Appraised value at date of death on note: _____

Distribution value on note: _____

_____

Promissory note: _____

Date of note: _____

Date of maturity of note: _____

Rate of interest: _____

Name of maker: _____

1st, 2nd, or 3rd deed of trust of note: _____

Address of collateral: _____

City: _____ State: _____

Estimated unpaid balance at date of death: _____

Unpaid balance at death on note: _____

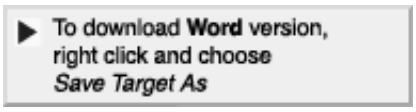
Accrued interest to date of death on note: _____

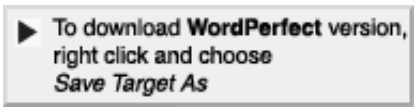
Appraised value at date of death on note: _____

Distribution value on note: _____

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§13.105 17. Form: Election to Have CPA Prepare Income Tax Returns





ELECTION TO HAVE CPA PREPARE PERSONAL AND FIDUCIARY TAX RETURNS

To: _ _[*name of attorney*]_ _

_ _[*Address*]_ _

Re: Estate of _ _[*name*]_ _

This document will serve to notify you that we have elected to have a certified public accountant prepare all federal and state fiduciary income tax returns, as well as any personal income tax returns required for _ _[*e.g., The Single Family Trust*]_ _**, acting as an administrative trust dated** _ _[*date*]_ _**, and all personal income tax returns for the above-named decedent. The name, address, and telephone number of my accountant are as follows:**

_ _[*Name*]_ _

_ _[*Address*]_ _

I hereby authorize you to write to my accountant to confirm your respective responsibilities for tax matters and to otherwise communicate with my accountant concerning any matters relevant to the planning of tax elections and distribution of the estate.

Date: _ _ _ _ _ _

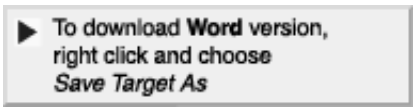
__[*Signature*]__
_ _[*Typed name*]_ _
Cotrustee of the _ _[*name*]_ _
Trust

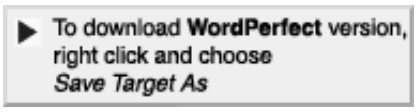
Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Cotrustee of the _ _[*name*]_ _
Trust

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§13.106 18. Sample Trustee's Letter to CPA





LAW OFFICES
GAW, VAN MALE, SMITH, MYERS & REYNOLDS

_ _[*date*]_ _

Our File: CURTIS-1

Anthony Gant, CPA
Beck, Marder, Beck & Gant
1500 Third Street
Napa, California 94559

Re: The Single Family Trust
Sue N. Curtis and Roy L. Page, Cotrustees

Dear Tony:

As you know, we represent Sue N. Curtis and Roy L. Page, as successor cotrustees of The Single Family Trust dated December 16, 2003 ("The Trust"), a living trust established by Mary Lea Single. Mary Lea Single died on October 1, 2009, as a result of which The Trust became irrevocable. The purpose of this letter is to confirm our respective responsibilities for tax-related services in connection with the Trust and Estate of Mary Lea Single. A copy of The Trust is enclosed for your records.

We wish to confirm that you will be preparing the following tax returns on Sue N. Curtis and Roy L. Page's behalf:

Personal income tax returns for Mary Lea Single

Fiduciary income tax returns for The Single Family Trust

Sue and Roy have requested that we prepare the federal and state estate tax returns. It appears that there will be some estate tax payable.

The due date for the 706 is July 1, 2009. Since our office will be preparing the 706 while your office will be preparing the personal and fiduciary returns, we need to coordinate our efforts to determine where to take deductions for last illness and administration expenses. We are enclosing some materials for your review which address the issue of where to take the deductions. Please contact our office so that we may determine where the deductions should be taken. Furthermore, please do not take expenses of last illness deductions on the decedent's final 1040 return, or administrative expenses on the 1041 return, without prior written understanding between our offices.

It appears that The Trust was substantially funded and that no formal probate of Mary Lea Single's Will is required. If assets outside The Trust otherwise subject to probate are found, these assets may be collected into The Trust using the Probate Code §13100 affidavit procedure, provided they have a total value less than $100,000. Should a formal probate become necessary, additional fiduciary returns for the probate estate may be needed unless an election is made to file only one fiduciary return and to elect a fiscal year end for this joint return, under Internal Revenue Code §645 (please see discussion below).

Under Treasury Regulation §1.645-1, if there is an executor, the following steps must be taken: The trustee of the trust and the executor of the estate must make an election to treat the trust as part of the estate. This is

done by the trustee and executor filing IRS Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." For the election to be valid, the election must be filed no later than the time prescribed under IRC §6072 for filing IRS Form 1041 for the first taxable year of the combined electing trust and related estate. The executor must file a complete IRS Form 1041 for the combined estate and trust for each taxable year during the election period. The trustee must provide the executor with all trust information necessary to enable the executor to file the IRS Form 1041.

If there is no executor, the following steps must be taken: The trustee must make the election by filing IRS Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." The election must be made by the time prescribed under IRC §6072 for filing IRS Form 1041 for the first taxable year of the electing trust. Please call us to discuss which year end to select. If the first fiduciary return is not the final return (because the trust administration continues beyond the selected year end), a final short-year return will also be due for the calendar or fiscal year in which the trust administration is completed.

According to the terms of The Trust, after payment of all administrative expenses, debts, and taxes, the trust estate will be distributed as follows:

(1) $100,000 outright to Roy L. Page

(2) Mobilehome to Sue N. Curtis

(3) Balance of estate split into two equal shares to be held in trust for Mary's children, Travis and Amy, until each reaches age 35.

The foregoing distributions will be made on completion of the formalities of the trust administration process, including the preparation of any required estate tax returns and trustee reports.

We are working with Sue and Roy to obtain appraisals of all trust and estate assets. In computing future depreciation deductions for tax purposes, you will need to use new depreciation schedules based on the date-of-death values (or alternate valuation date, if applicable). We will forward appraisal information to you as it is received by our office.

We have obtained the following taxpayer identification number for The Trust: 94-1164957.

We have advised Sue and Roy to establish a separate checking account for The Trust using the foregoing TIN and to pay all expenses and deposit all income relating to The Trust from and to this account.

We anticipate that Sue and Roy will prepare a formal fiduciary account and report for all beneficiaries of The Trust. Even if no formal account and report is given, an internal accounting will be necessary for income tax and asset allocation and distribution purposes. It is our understanding that our office will be responsible for preparing the fiduciary accounting.

We would appreciate your sending us copies of all tax returns that you file on behalf of decedent or The Trust so that we may keep our records up to date. We will do likewise.

If the foregoing allocation of responsibility is not to your understanding, please let us know as soon as possible. We appreciate your cooperation in this matter and look forward to working with you.

Very truly yours,

GAW VAN MALE

DAVID B. GAW

Enclosures

cc: Sue N. Curtis

Roy L. Page

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§13.107 19. Form: Letter of Instructions for Completing Asset Collection Sheet

▶ To download **Word** version, right click and choose *Save Target As*

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

File No.:

_ _[*Name*]_ _

_ _[*Name*]_ _

_ _[*Address*]_ _

Re: List of Assets

Dear _ _[*name*]_ _ and _ _[*name*]_ _ :

Enclosed is a partially completed Asset Collection Sheet that we reviewed during our first meeting. Using the attached "list of assets" to get you thinking about the types of assets we are looking for, please complete the enclosed form to the best of your ability.

Should you have any questions or find the form too difficult to complete, please contact our office.

Sincerely,

__[*Signature*]__
_ _[*Typed name*]_ _

Enclosure

INSTRUCTIONS FOR COMPLETING ASSET COLLECTION SHEET

For real estate, indicate the estimated value and, immediately below that, the estimated total encumbrances.

For brokerage accounts, bank accounts, mutual fund accounts, and any similar accounts, please include the name and address of the institution and the account number or numbers. For stock certificates not held in a brokerage account, please provide copies of the certificates. Do not list any IRA, 401(k), or similar accounts here. These should be listed under the "Annuities, IRAs, and Retirement Benefits" category.

For mortgages and notes, provide a copy of the note and (if secured) the deed of trust and indicate the present outstanding balance according to your records.

For life insurance, please list the name of the company, the policy number, the present cash value (if applicable), and the face value. Also send us a copy of the most recent beneficiary designation.

For business interests, please indicate the form of business entity (corporation, partnership, sole proprietorship, limited liability company, etc.) and include copies of any buy-sell agreements. If the business is in corporate form, you will need to bring in your corporate minute book and stock ledger. Also indicate whether an "S corporation" election has been made. For partnerships, please provide a copy of the partnership agreement.

For miscellaneous items, do not itemize separately if the value of an item or collection of items is less than $3000.

The following is a list of the categories on the form and the types of assets that fall within each category:

Real Property	Securities
Personal residence Rental property Condominiums Interests under installment land contracts Vacation homes Undeveloped land Commercial property Time shares Mineral rights Leasehold interests Options to purchase real property	Stocks Bonds Debentures Treasury notes and bills U.S. Savings Bonds Mutual funds Brokerage accounts Stock options Publicly traded limited partnerships
Bank, Savings & Loan, and Credit Union Accounts	**Mortgage and Notes**
Bank accounts Savings and loan accounts Credit union accounts Certificates of deposit Savings accounts Checking accounts Nonbrokerage money market accounts Pay-on-death accounts "Trustee" accounts	Secured notes Unsecured notes Deeds of trust Undocumented loans you've made
Business Interests	**Life Insurance**
Closely held corporations General partnerships	Whole life policies Term policies

Limited partnerships (other than publicly traded) Limited liability companies Sole proprietorships Equipment used in business	Universal life policies Group life insurance through your employment
Annuities, IRAs, and Retirement Plans	**Miscellaneous**
Tax-deferred annuities Immediate pay annuities Individual retirement accounts (IRAs) Qualified retirement plans Profit-sharing plans Pension plans Defined contribution plans 401(k) plans Keogh plans SEP plans PERS/STRS plans Salary continuation plans	Household furniture and furnishings Antiques Cars Trucks Boats Recreational vehicles Mobilehomes Art, wine, coin, and stamp collections Country club memberships Copyrights Patents Royalties Beneficial interests in trusts created by others Livestock (cattle, horses) Inheritance expected in near future

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§13.108 20. Form: Attorney's Letter to Appraiser

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

File No.:

_ _[*Name*]_ _

_ _[*Name of firm*]_ _

_ _[*Address*]_ _

Re: Estate of _ _[*name*]_ _**,** _ _[*e.g., The Single Family Trust*]_ _

Date of Death: _ _[*date*]_ _

Trustees: _ _[*name*]_ _ **and** _ _[*name*]_ _

Appraisal of Real Properties at:

1. _ _[*address*]_ _

2. _ _[*e.g., Casual Aire double-wide mobilehome DCAL No.* _ _[*fill in number*]_ _]_ _**, located at** _ _[*address*]_ _

Dear _ _[*name*]_ _**:**

This letter confirms our telephone conversation of today, in which I informed you that this firm represents _ _[*name*]_ _ **and** _ _[*name*]_ _**, as Trustees of The** _ _[*e.g., Single Family Trust*]_ _**. Said trust was established under a Declaration of Trust signed by** _ _[*name*]_ _ **as settlor on** _ _[*date*]_ _**.** _ _[*Name*]_ _ **died on** _ _[*date of death*]_ _**. We are gathering information and appraisals on all of** _ _[*name*]_ _**'s properties as of** _ _[*date of death*]_ _**.**

In our telephone conversation, you agreed to prepare separate formal appraisals for the above properties. Please note the appraisal is for our firm and not for the trustees. You have quoted an appraisal fee of _ _[*dollar amount*]_ _ **for the properties listed above.**

It is absolutely imperative that the appraisals be as of _ _[*date of death*]_ _**. Each separate appraisal should contain the following:**

1. A dated letter on your letterhead clearly stating the fair market value of the subject property (with address/APN) as of _ _[*date of death*]_ _**. (The value cannot be given as a range.)**

2. A table of contents.

3. A property description and analysis of the subject property.

4. A floor plan of the subject property.

5. Photographs of the subject property including front, rear, and street scene.

6. At least three (3) comparables, with photographs of the front of each comparable.

7. A map, with the subject property and each comparable clearly identified.

8. A plat of the subject property, with the subject property clearly identified.

9. A history or list of your qualifications as an appraiser.

You should contact _ _[*name*]_ _ at _ _[*telephone number*]_ _ to make arrangements to view the property and so that she can prepare _ _[*name of decedent*]_ _'s children for your visit.

The appraisals and your statements for your services should be sent to our office. If you have questions or if I can assist you, please telephone me at _ _[*telephone number*]_ _.

Sincerely,

__[*Signature*]__
_ _[*Typed name*]_ _

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§13.108A 21. Form: Attorney's Letter Requesting Copy of Gift Tax Return

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

File No.:

Internal Revenue Service
RAIVS Team
P.O. Box 9941
Mail Stop 6734
Ogden, Utah 84409

Re: Estate of _ _[*name*]_ _, Deceased

SSN: _ _[*number*]_ _

Enclosed is a Request for Copy of Tax Return (IRS Form 4506) requesting copies of IRS Forms 709 filed by the above-named decedent during the tax years _ _[*years*]_ _, together with our check number _ _[*number*]_ _ in the amount of _ _[*dollar amount*]_ _ to cover the fee (_ _[*number*]_ _ tax years at _ _[*dollar amount*]_ _ each).

If you have any questions, or need further documentation, please contact the undersigned.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Enclosures

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§13.109 22. Form: Trust Administration Memorandum

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TRUST ADMINISTRATION MEMORANDUM

Provided to _____,

Cotrustees of The _____Family Trust

[*Law firm name and address*]

Date: _____

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MEMORANDUM REGARDING TRUST ADMINISTRATION

I. INTRODUCTION

The average person has had little experience dealing with trusts and often has many questions upon becoming a trustee for the first time. The purpose of this memo is to try to anticipate your questions by providing a general overview of how trusts work and your duties and responsibilities as trustee.

Through our experience in helping people administer trusts, we have found that many individuals have unreasonable expectations concerning the way living trusts operate following a death. It is true that a living trust in many cases drastically reduces the costs and delays involved in passing on assets at death. A living trust accomplishes this feat by avoiding probate.

However, even without a probate, many administrative chores have to be completed, legal documents prepared, taxes returns filed, and other matters that take time and cost money.

II. TRUSTS IN GENERAL

A. What is a Trust?

A trust is a legal relationship, usually evidenced by a written document called a "Declaration of Trust" or "Trust Agreement," whereby one person, called the "Settlor," transfers property to another person, called the "Trustee," who holds the property for the benefit of another person, called the "Beneficiary." The same person may occupy more than one position at a time. For example, in the typical living trust, as long as the Settlor is alive, he or she is also the Trustee and Beneficiary. On the death of the Settlor, a "Successor Trustee" (*e.g.,* child, friend, bank) takes over as Trustee and follows the Settlor's instructions, which are set forth in the Trust, concerning the distribution of property and the payment of taxes and expenses.

B. Living Trusts and Probate Avoidance

Although living trusts have been around for centuries, only recently have they achieved a high degree of popularity among the general public. The reason for this surge in popularity is that living trusts help to avoid probate. You might be wondering, "What is probate, and why is everyone trying so hard to avoid it?" The short answer is that probate is a court-supervised procedure for collecting a deceased person's assets, paying debts and taxes, and distributing the property to the person's beneficiaries (either according to the instructions the person set forth in his or her will or as determined by state law if the person died without a will). The probate process usually takes 6 to 12 months to complete, although it may take longer in complicated cases.

Probate is not a tax. When people refer to the high costs of probate, they are usually referring to the fees paid to attorneys and the personal representative. In California, these fees are calculated as a percentage of the gross (not net) value of the assets in the estate. These rates are set out in Probate Code §§10800 and 10810 (4 percent on the first $100,000, 3 percent on the next $100,000, 2 percent on the next $800,000, and so on). For example, let's say that *D*, who is not married, dies owning one asset, a house worth $200,000 with a mortgage of $120,000. *D* has a will that leaves the house to *D*'s two children, *A* and *B*. *A* is named as executor. The probate fees for this case would be as follows: $7,000 to *A*'s attorney (plus any "extraordinary fees," which are billed hourly but subject to court approval) and $7,000 to *A* (if *A* decides to take a fee), for a minimum total fee of $14,000. These fees are calculated without regard to the $120,000 mortgage, because the fees are charged on the gross (not net) value of the estate.

One of the reasons living trusts have become so popular in the last 20 years is that real estate prices in California have skyrocketed, leading to much larger estates and, hence, higher probate fees. In states where real estate prices are lower or where attorney fees for probate work are based on an hourly fee schedule rather than a percentage scale, living trusts are less popular than in California.

Living trusts avoid probate with respect to those assets that are transferred into the living trust before death. In other words, living trusts avoid the court procedure otherwise required to transfer assets to a person's beneficiaries at death. However, as we explain below, even though no court procedure is involved, that does not mean there is nothing to do. The living trust makes administration easier, but it does not do away with administration altogether. For example, assets still have to be collected and managed pending distribution to the beneficiaries, appraisals of assets have to be made, debts and taxes have to be paid, tax returns may be required (living trusts do not avoid estate taxes, as some people have been led to believe), and legal documents must be prepared in connection with the distribution of the trust property to the beneficiaries. These activities are very similar to a probate. The major difference is that, with a living trust, everything is handled privately, without court supervision, which makes for (in most cases) a faster, less expensive administration process.

Thus, although it may come as a surprise to you, you should realize that postdeath administration of a living trust will take time and cost money, such as legal fees, accounting fees, asset transfer fees, and your own Trustee fees if you decide to accept any. The other beneficiaries of the Trust, if any, will also need to understand that the process may take longer than they anticipated. However, in comparison to probate, these delays and costs are substantially reduced, often resulting in time savings of months and costs savings of 50 to 90 percent.

C. Court Involvement

There is also a popular misconception that the existence of a living trust avoids all possibility of court involvement. This is true (in part) only if all of the Settlor's assets were properly funded into the living trust. For example, if assets held outside the trust exceed $100,000 in gross value, a probate will be required for those assets in order for you, as Trustee, to collect those assets and add them to the trust.

Moreover, if at any time a beneficiary of the Trust believes that the Trustee has acted improperly or without regard for the beneficiary's interests, the beneficiary may file a petition with the court to force the Trustee to make a full report and accounting or to redress an alleged breach of trust, including removal of the Trustee or surcharge against the Trustee.

Finally, circumstances may arise in which there are questions about whether the Trustee should or should not take certain actions (*e.g.,* selling a business interest or real property, commencing litigation). In such cases, it may be advisable for the Trustee to petition the court for instructions whether to proceed in a certain way. The beneficiaries will be given notice of the hearing and will be given a copy of the petition that describes the proposed action. The matter will then be addressed in open court, and the beneficiaries will have an opportunity to appear in court and be heard. By obtaining an order from the court in this manner, the Trustee may be able to cut off the beneficiary's right to complain about the particular action if he or she fails to appear in court. Such a petition protects the Trustee if there is a fear that the Trustee's decision will be second-guessed by a beneficiary. Also, if relations between the Trustee and the beneficiaries are hostile, it may be advisable for the Trustee to seek court approval of the Trustee's accountings to minimize potential arguments with the beneficiaries.

III. ADMINISTRATION OF THE FAMILY TRUST

After the Settlor's death, the Trust continues as a management and distribution vehicle that will exist only as long as is necessary to identify and collect trust assets, pay debts and taxes, and distribute the trust assets to the beneficiaries (or in further trust, depending on the terms of the Trust). You might visualize this trust as a funnel through which all of the trust assets will pass to the beneficiaries (with the exceptions of tangible personal property, life insurance proceeds, and other nontrust assets that may pass directly to the beneficiaries outside the Trust). As successor Trustee, it is your job to collect and manage the trust's assets, appraise trust property, pay all taxes and expenses relating to the administration of the Trust, and distribute the trust property according to the Settlor's instructions.

IV. POUROVER WILLS

In addition to the Trust, the Settlor signed what we call a "pourover" will. The purpose of the pourover will is to provide for the distribution of assets that were omitted from the Trust, either intentionally or inadvertently. One of your first tasks will be to determine what assets, if any, were omitted from the Trust. If any such assets exceed $100,000 in gross value, a probate may be required to transfer these assets to the Trust. If these assets do not exceed $100,000 in value, you can collect such assets under a declaration procedure authorized by the Probate Code. At least 40 days must elapse after the date of death before you can use this declaration procedure. Whether or not a probate is required, the original will must be deposited for safe keeping with the County Clerk within 30 days of the date of death.

V. DISTRIBUTIONS OF PROPERTY

A. Tangible Personal Property

Provided the beneficiaries are in agreement, the distribution of tangible personal property may be handled informally and we need not get involved. If any disagreement develops, however, the division of personal property should be handled in a more formal manner. We recommend that you carefully document and inventory the items of property available for distribution and the disposition of each. One way to document the property on hand is to videotape or photograph the household property before distribution.

Before allowing the distribution of any items of personal property, however, please note that you are responsible for reporting such items on a federal estate tax return, if required (see below). Furthermore, if any items of property (or group of items that constitutes a single collection) have a fair market value of $3,000 or more, these items must be separately appraised for federal estate tax purposes. You should therefore keep careful records of what assets are distributed and to whom, and you should obtain any required appraisals before distributing particularly valuable items.

B. Other Distributions From the Trust

One of the first questions the Trustee and other beneficiaries usually ask us is, "When will the trust property be distributed?" Many people, having heard that living trusts avoid probate, assume that all estate administration procedures are avoided and that the property in the living trust somehow passes to them automatically. Having read this far, you now understand that this simply is not true. As a result of this misunderstanding, many beneficiaries are disappointed to learn that the trust administration process is often measured in weeks or months (and in some cases longer), rather than in hours or days.

In answer to the question of when distribution will take place, we anticipate that distribution will take place in several stages. Depending on how quickly assets and liability information can be assembled, you may be able to make preliminary distributions of a portion of the trust estate within a few weeks. After we have obtained all appraisals and can project the expected tax liabilities and expenses with more accuracy, you may distribute more of the trust estate, making certain to reserve sufficient funds for payment of estate taxes, income taxes, administrative expenses, attorney and trustee fees, debts and liabilities, etc. However, if any litigation arises concerning the Trust (*e.g.,* a "contest" of the Trust), you may have to withhold distribution until such problems have been completely resolved. (Our office has had cases in which a living trust that provided for distribution "at death" was not actually distributed until more than a year after death because of disagreements among the beneficiaries and the ensuing court procedures.)

Moreover, as noted above, living trusts do not avoid estate taxes. If it is determined that estate taxes or

fiduciary income taxes are payable in this case, we will recommend that you retain a further reserve in the Trust after payment of such taxes until all audits are completed or until the period for assessment of a tax deficiency passes (3 years). This reserve is for your own protection. Any legal fees, accounting fees, and your own Trustee fees incurred in connection with the audit process, and any tax deficiencies that might be assessed by the IRS, are chargeable to the Trust. If you have already distributed all of the trust assets, you, as Trustee, may have to bear these expenses and taxes yourself if the beneficiaries are unwilling or unable to contribute their fair share. If this situation applies in your case, we will assist you in determining an appropriate amount to hold as a reserve.

VI. TRUSTEE DUTIES, POWERS, AND COMPENSATION

A. Standard of Trust Management

As Trustee, you will act in a fiduciary capacity. As such, you owe certain legal duties to the beneficiaries, as explained in more detail below. In managing the trust property, you must use at least ordinary business ability. However, if you have special skills, under California law you will be held to a higher standard of care. In any event, your management will be judged in light of the circumstances existing at the time transactions occur, rather than with the benefit of hindsight. If you exceed your trustee powers, you may be held liable for loss or damage to the trust estate.

B. Source of Trustee Powers

It is important that you understand the rules under which you must operate. These rules are derived from three sources: (1) the Trust itself, (2) statutory law (the "Trust Law" found in the California Probate Code), and (3) decisional law created by the courts.

The principal source of your Trustee powers is the Trust itself. You should therefore read the Trust carefully. In doing so, you will see that the Trust contains two types of provisions: (1) "dispositive provisions" that govern the distribution of property and (2) "administrative provisions" that govern the powers of the Trustee, payment of taxes and expenses, rules for interpreting the trust instrument, and other procedural issues. The bulk of the Trust is made up of these administrative provisions.

In creating a trust, the Settlor may include any lawful provisions that he or she wishes to govern the trust relationship. Because tax considerations are often important in creating a trust, the Trustee's rights and duties are often limited by the tax results desired by the Settlor. The provisions of a trust may override general provisions of the Trust Law, except when the law expresses a paramount public policy. Whenever the trust instrument does not provide for a given situation, the Trust Law applies.

C. General Duties of Trustee

Your basic duties as Trustees involve the collection, management, and investment of trust assets and the accumulation and distribution of income and principal under the Trust. Another important set of duties relates to tax matters, which are explained in detail elsewhere in this memo.

It is a fundamental principle of trust law that you must be faithful to the interests of the Trust and its beneficiaries. You occupy a position of trust and confidence and owe a duty of care to the beneficiaries. You have a duty to administer the Trust solely in the interest of the beneficiaries and to deal impartially with them. You cannot use trust property for your own profit or for any nontrust purpose. You must not engage in any transaction that will result in a conflict of interest between you and the Trust or a beneficiary.

You have a duty to take reasonable steps to take and keep control of trust property and to preserve the trust property and make it productive. You must not commingle trust property with your own property under any circumstances. You also have a duty to take reasonable steps to enforce claims of the Trust and to defend lawsuits brought against the Trust.

You must carry out all Trustee activities personally. In other words, you may not delegate your responsibilities to others. However, you may hire attorneys, accountants, investment advisors, and others to consult with you concerning your administration of the Trust. Nevertheless, you will ultimately be held responsible for your acts or omissions.

D. Uniform Principal and Income Act

The Uniform Principal and Income Act (Probate Code sections 16320-16375) went into effect January 1, 2000, and significantly changed the way in which a trustee should think about principal and income.

In the past, "income" beneficiaries and "principal" beneficiaries were treated differently. The right to income has most often been thought to include the right to payment of dividends, rents, royalties, and similar items received as a current return on an investment. The notion of "current return on an investment" often coincides with that of "ordinary income" for income tax purposes. Capital appreciation was thought to accrue for the benefit of the principal beneficiaries, who most often were entitled to distributions following the termination of the income beneficiaries' interests. (Many trusts provide for invasion of principal for various purposes prior to the termination of the income beneficiaries' interests.) Those who are entitled to receive the trust assets at the termination of the trust are often referred to as "remainder beneficiaries," the ultimate class of principal beneficiaries.

As a result of these traditional notions of "principal" and "income," an inherent conflict was created that affected the way in which trust assets could be invested. Income beneficiaries would clamor for investments in income-producing assets (high-yield bonds, for example) while the principal beneficiaries demanded that the trustee take positions that produce capital appreciation. The trustee was required to do both or face the consternation of one class of beneficiaries.

The Uniform Prudent Investor Act became law in 1996 (see discussion below in paragraph E), and the trustee was instructed to make investment decisions "not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." (Probate Code section 16047(b).) The trustee was given a duty to diversify the investments of the trust. (Probate Code section 16048.)

Since you will be acting as the trustees of ongoing trusts after the termination of the administration period, it will be necessary to track principal and income. Therefore, every time your CPA prepares the fiduciary tax return, he should also give you a breakdown of trust income and principal for trust accounting purposes.

E. Trust Investments

The Uniform Prudent Investor Act (the "Act") (Probate Code sections 16002(a), 16003, 16045-16054) was added to the California Probate Code in 1996. Under the Act, a trustee, who invests and manages trust assets, must comply with the "prudent investor rule." The Act sets forth a framework which describes the prudent investor rule with regard to standard of care, portfolio strategy, risk, diversification, delegation, costs, and compliance standards. The law is of considerable advantage to trustees because it provides common sense investment guidelines. Furthermore, it provides a favorable procedure for reviewing the trustee's actions that examines the investments made by the trustee in the context of the entire trust portfolio instead of viewing each asset in isolation. The basic reasons for establishing the Act were:

(1) Portfolio rather than individual investments;

(2) Trade off in investing between risk and return;

(3) No categoric restrictions on types of investments;

(4) Requirement to diversify investments; and

(5) Delegation of investment and management functions by trustee permitted.

The Act sets forth a laundry list of circumstances that are appropriate for a trustee to consider with regard to investments decisions: (1) general economic conditions; (2) inflation and deflation; (3) tax consequences; (4) the role each investment or course of action plays within the overall trust portfolio; (5) the expected return from income and the appreciation of capital; (6) information provided to the trustee from the beneficiaries; (7) needs for liquidity, regular income and preservation of capital; and (8) an asset's special relationship to the trust or to a beneficiary. (Probate Code section 16047(c).)

Under the Act, as trustee, you are now provided with statutory protection when treating one asset differently

from the norm if that particular asset has a special relationship to the trust or a beneficiary. More significantly, your course of action is now evaluated in the context of the "trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust." (Probate Code section 16047(b).) No longer are the trustee's individual asset investment decisions viewed in isolation. For example, if a trustee's investment of a specific asset were to generate a loss, this loss would be viewed in light of the entire trust portfolio. The trustee could have accepted the loss in order to offset other income of the trust or to allocate trust resources to less risky assets. The Act does not, however, shield you from liability in making unsound investments or failing to exercise your power of investment in the best interests to the trust.

Under the Act, a trustee is charged with the duty to diversify the investments when making and implementing the investment decisions. (Probate Code section 16048.) In addition, the Act sanctions the trustee's ability to delegate investment and management functions. (Probate Code section 16052.) However, the trustee is required to exercise prudence in the selection of an agent, to establish the terms/scope of the agent's duties and to periodically review the agent's overall performance and compliance with the terms of the delegation. This delegation does not permit you to avoid all responsibility. You must continue to take an active role in evaluating the agent. If you have any questions about the propriety of any investment, you should seek legal advice before making or continuing the investment.

F. Providing Information to Beneficiaries

Under the Trust Law, you owe a duty to the beneficiaries to make them aware of the existence of the Trust and to keep them reasonably informed of the Trust and its administration. We will discuss with you what specific actions you and we will take to fulfill this duty.

State law also requires that you provide the beneficiaries with certain information on reasonable request and that you give a full accounting and report of all trust transactions not less often than annually or at the termination of the Trust or on a change of trustee (see Probate Code section 16062), unless the Trust instrument or a beneficiary waives this requirement in writing. (While these provisions of law technically apply only to trusts created on or after July 1, 1987, it is good practice to follow these laws no matter when the trust was executed.) The subject Trust does not waive this requirement.

Even if a formal accounting was not required, we would strongly recommend that such accountings be prepared and presented to the beneficiaries. In any event, internal accountings will be needed to provide a permanent record of trust transactions, to distinguish between principal and income transactions, and to provide a single source of data for preparation of income tax returns. Because this information must be recorded and assembled anyway, it makes sense to give this information to the beneficiaries for a number of reasons. First, it will give the beneficiaries a better understanding and appreciation for the complexity of your job as Trustee and the amount of work involved. Second, it will help to avoid misunderstandings by disclosing all relevant transactions. Third, it will start the running of a 3-year statute of limitations for all matters you disclose in the accounting. If no accounting is made, there is no statute of limitations and your liability exposure continues indefinitely.

Please note that a trust accounting is a legal document that should be prepared by a lawyer to make certain that it meets the format required by the Trust Law. Only in this way can you be assured that the 3-year statute of limitations begins to run. CPAs are not always experienced in fiduciary accounting standards and you should not rely on financial statements prepared by an accountant to satisfy the fiduciary accounting requirements of the Probate Code.

Although making formal accountings will add to the expense of administration, bear in mind that the cost is payable from the Trust (not from your own pocket, except to the extent of your prorata share if you are also a beneficiary) and is tax deductible. Because the cost is payable from the Trust, it is spread among all the beneficiaries. In other words, all of the beneficiaries will share the cost of protecting you from subsequent liability. You should give serious consideration to taking advantage of this benefit even if the Trust does not require accountings or the beneficiaries are willing to waive this requirement. Although we recommend that formal trust accountings be prepared, if you would prefer to request that the beneficiaries waive the requirement of a formal trust accounting, please let us know and we will prepare the appropriate waiver forms.

G. Recordkeeping

Regardless of whether you intend to make a formal accounting to beneficiaries, you must keep careful

records of all trust transactions. In fact, if you do not prepare a formal accounting, you should probably keep these records forever, because there is no statute of limitations and your liability exposure will continue indefinitely.

In particular, you must keep an accurate bookkeeping ledger, with descriptive notations of all income and receipts, noting for each entry the date, the person to or from whom payment was made or received, the nature of the payment, and the amount. All disbursements for trust expenses should be made by check. You should never pay cash for any trust expenditure. You should keep a file or set of files in which you keep a copy of the trust instrument and your financial records for the Trust, including bank statements, statements of income received, bills for expenses, bank deposit receipts, canceled checks, copies of tax returns, and copies of correspondence relating to the Trust.

If the Trust has a large number of assets or transactions, you may find it helpful to set up a more sophisticated bookkeeping system. If you own or have access to a personal computer, you might consider using a household or business accounting software package or general spreadsheet program to keep track of trust transactions. We would be happy to help you or recommend someone to assist you in setting up a bookkeeping system that best fits your needs.

Whatever bookkeeping system you choose, it is essential that you keep us informed of your activities by sending us copies of your checkbook register, ledger sheets, computer printouts, bank statements, securities account statements, etc., on a regular basis so that we can monitor whether you are keeping adequate records and properly handling trust accounting procedures. If we do not receive these documents on a regular basis, we will send you a reminder in writing. If you persist in not providing this information, we reserve the right to withdraw as your attorneys.

If you have not already done so, you should immediately open a checking account with a financial institution of your choice in your name as Trustee of the Trust. To do this, you will need to take an original Certification of Trust to the bank. We have prepared or will prepare several such documents for your use. Do not use your own Social Security number or that of decedent on this account. You should instead use the employer identification number that we have obtained (or will obtain) for the Trust. All trust expenses should be paid from, and all trust income should be deposited to, this trust checking account. Do not continue to write checks against or use any account standing in the name of Settlor for any trust transactions.

H. Trustee Compensation

Under the terms of the Trust and the Trust Law, you are entitled to reasonable compensation for your services as Trustee. In determining reasonableness, factors such as the amount of time spent in trust administration and the size of the trust estate may be considered. You do not have to accept a trustee's fee. If you do, you should know that it is reportable as taxable income.

Whether or not you accept a fee, we strongly recommend that you keep a log or diary of the time you spend on trust matters, including the date, amount of time expended, what you did, and the decisions you made and the basis for the decisions. If you incur miscellaneous expenses for which you expect reimbursement from the Trust, you should carefully record these expenses. This log or diary will not only support your request for trustee's fees (if you decide to accept a fee), but will also serve as a written record of the actions and your thoughts surrounding those actions in the event your activities are ever questioned by a beneficiary of the Trust.

VII. TAX MATTERS

A. Taxpayer Identification Number

We have obtained a taxpayer identification number for the Trust, which is 94-1164957. You should transfer the title on all bank and brokerage accounts standing in the name of the Settlor to your name as Trustee. Use only the new taxpayer identification number on such accounts and not the Settlor's or your own social security number.

B. Notice Concerning Fiduciary Relationship

Federal and state laws require that the respective taxing authorities be notified of the existence of a new

trust or a change in fiduciary relationship. Because the Trust is now irrevocable and has in essence become a separate taxable entity, we must notify the taxing authorities of its existence. This is done by way of a "Notice Concerning Fiduciary Relationship" (IRS Form 56). We will prepare this notice for you.

C. Estate and Gift Taxes

Depending on the size of the estate, estate tax returns may be required and estate taxes may be payable. Under current law, an estate tax return is required in any case in which a decedent's gross estate exceeds _ _[*e.g., $3,500,000 in the year 2009*]_ _ in value. The "gross estate" includes any property interests of the decedent at the time of death, including but not limited to property in a probate estate, property in a living trust, and joint tenancy property. In other words, the gross estate for tax purposes is not the same thing as the "probate estate." In fact, someone could avoid probate altogether by having a fully funded living trust, but that does not mean that no estate taxes will be payable.

As successor Trustee, it is your responsibility to file all required federal and California estate tax returns (IRS Form 706 and California State Form ET-1, respectively). If, on the other hand, a probate is required, it is the executor's responsibility to file such returns. If required, we will prepare any estate tax returns for you, although your cooperation will be essential in providing us with all necessary asset and liability information in order to prepare accurate returns. The estate tax returns, if required, and any tax due, must be filed within nine (9) months following the date of death, *i.e.*, _ _[*date*]_ _.

Our preliminary analysis of assets indicates that an estate tax return will be required. As part of the process for collecting asset values, we will need to obtain appraisals for values of trust assets. To determine the necessity for and in connection with the preparation of the estate tax returns, we will need to know the fair market value of all assets in the Trust or owned by Settlor outside the Trust at the time of death. For real property, closely held business interests, and tangible personal property, qualified appraisals will be required.

In addition, if Settlor made any gifts during the year of death (or any prior year for which no gift tax return was filed) that exceeded $10,000 per donee per year, plus inflation adjustments for years after 2001 ($11,000 per donee in 2002-2005, $12,000 per donee in 2006-2008, $13,000 in 2009), you (or the executor of the estate if there is a probate) will also be required to file a gift tax return to report such gifts. If you know of any such gifts, please let us know.

D. Alternate Valuation Date

For federal estate tax purposes, you may elect to use the values of the assets of either the date of death or at the "alternate valuation date," which is either 6 months after death or, for assets sold or distributed before that date, the date of sale or distribution. Whichever valuation date you choose, that date must be used for valuations of all trust assets. In addition, you can use alternate-valuation-date values only if the effect would be to reduce the estate tax liability. (For example, if there is no estate tax payable, you cannot use alternate valuation simply to get a higher income tax basis.) If you wish to use the alternate valuation date, each asset will have to be appraised not once but twice: once at the date of death and again at the date that is either 6 months later or the date of distribution.

E. Income Taxes

1. Income Tax Basis

For federal and state income tax purposes, all of the property in the Trust (other than assets which are "income in respect of decedent" or IRD) will receive a new income tax basis equal to the fair market value at the date of death (or the alternate valuation date, as explained above). This new basis is the measuring point for any capital gains in the event you sell any property of the Trust or for any depreciation deductions pending administration.

2. Income Tax Consequences to Beneficiaries

All property received by inheritance, including property distributed from a living trust, is received free of income tax. However, some income tax consequences to the beneficiaries should be noted. One such consequence is that the basis of assets received on distribution will be the date-of-death value (or alternate-valuation-date value), as explained above. The income tax basis of assets received will determine the capital

gain a beneficiary will realize if and when the beneficiary sells an inherited asset.

In addition, the beneficiaries of any residuary gift must be aware that the distribution of trust assets will carry out to the beneficiaries income earned by the Trust during the period of trust administration to the extent of basis, which income will be reportable on the beneficiaries' own individual tax returns. The Trust will supply the beneficiaries with K-1s reporting the amount of income passed through to the beneficiaries. Alternatively, before this distribution of income to a residuary beneficiary, the Trustee may make an election under Internal Revenue Code §643(e) to recognize the gain at the trust level, in which case the distribution and basis to the beneficiary are increased to fair market value. If the beneficiaries have already filed their returns for a taxable year before obtaining K-1s, they will be required to file amended returns.

Finally, some assets, such as IRAs, retirement plans, and certain annuities will be partly or fully taxed as income to the beneficiary of any such asset.

3. Decedent's Final Returns

Final state and federal personal income tax returns will be required for the period of January 1 through the date of the Settlor's death. Such returns will include income generated by the assets of the Family Trust before the date of death. Income generated by the assets in the Trust after the date of death is reportable on the fiduciary returns (see below).

4. Fiduciary Returns

All trusts that meet certain minimum income limits are required to file fiduciary tax returns (state FTB Form 541 and IRS Form 1041) either on a calendar-year (tax year ending December 31) or fiscal-year basis. In the event that we elect to use a calendar year end, the Trust's first taxable year will be a short taxable year commencing with the date of Settlor's death and ending on December 31, or earlier date if trust administration is completed before that date. The returns for this period will be due on April 15 of the year following the year of death. If we use a fiscal year end, the returns will be due on the 15th day of the fourth month following the end of the fiscal year end. We will make a determination as to which year end to use in coordination with your tax professional or tax preparer.

We have already communicated with your tax professional, _ _[*name*]_ _, concerning these issues, and we understand that _ _[*he/she*]_ _ will be handling the preparation of fiduciary returns both for the probate estate (if any) and the trust.

VIII. ATTORNEYS' ROLE

As your attorneys, our job is to assist you in carrying out your duties as Trustee as described in this memo. We will help you collect and value assets, pay debts and taxes, and prepare the necessary transfer documents in connection with the eventual distribution of trust property to the appropriate beneficiaries. We will also prepare any accountings and reports to be given to the beneficiaries, if required, and we will give you advice concerning tax matters and prepare any required estate tax returns. If you so request, we will also prepare fiduciary income tax returns for the various Trusts. If any court action is necessary, we will represent you in that action. The exact nature and scope of our services is set forth in the separate engagement letter that you have signed.

Please keep in mind that we represent you and do not represent any other beneficiaries of the trust. Any communication between you and our firm is subject to the attorney-client privilege and will be kept confidential. With your permission, we may provide information to other beneficiaries and answer some of their questions. However, it is inappropriate for us to give them legal advice. Furthermore, because you are a beneficiary as well as the Trustee, we cannot render any advice to you in your capacity as a beneficiary if it would conflict with your duties as Trustee. Doing so might constitute a conflict of interest and a violation of our ethical requirements under the State Bar Rules.

IX. CONCLUSION

This memo is intended to serve as an overview of the trust administration process and your duties as Trustee. It is not intended to anticipate every possible question or problem that may arise during the course of administration of the Trust. If any questions or problems arise that are not adequately explained by this memo

or by reference to the Trust itself, please contact our office first, before taking any action.

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§13.110 23. Form: Liquidity/Cash Needs Analysis

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ESTATE OF _ _[*name*]_ _
LIQUIDITY/CASH NEEDS ANALYSIS

PURPOSE	AMOUNT
1. Debts (other than secured)	_____
2. Unpaid income taxes	_____
3. Unpaid gift taxes	_____
4. Estimated trustee fees	_____
5. Estimated attorney fees	_____
6. Estimated appraiser fees	_____
7. Estimated CPA fees	_____
8. Federal estate tax	_____
9. Miscellaneous administration costs	_____
10. Cash bequests	_____
11. Other	_____
Total cash required	$_____
Cash on hand	($_____)
Estimated income	_____
Less estimated income tax	($_____)
Cash to be raised from liquidation of assets	$_____

PREPARED BY: _ _[*name*]_ _

DATE: _ _[*date*]_ _

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§13.111 24. Form: Trustee's Letter to IRS

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_ _[*Name*]_ _

_ _[*Address*]_ _

_ _[*Date*]_ _

Internal Revenue Service

_ _[*Address* _ _[*e.g., Ogden, Utah 84201*]_ _]_ _

Re: Estate of _ _[*name*]_ _**, Deceased**

SSN: _ _[*Social Security number*]_ _

Dear Sir or Madam:

The above-referenced decedent established a revocable trust (The _ _[*name of trust*]_ _**, created on** _ _[*date*]_ _**) before her death, and we are the successor trustees of said Trust. There will be no probate of this estate.**

We hereby apply for determination by you of the amount of the estate tax for the above decedent and request a discharge from personal liability for the tax, in accordance with Internal Revenue Code section 2204.

Accompanying this request is a copy of the Declaration of Trust and a description of the property transferred to us as trustees of the Trust, as well as a Certification of Trust, which serves as a verification of our authority to act under the Trust.

Date: _ _ _ _ _ _

Sincerely,
_ _[*Typed name*]_ _
_ _[*Typed name*]_ _
Cotrustees of
The _ _[*name of trust*]_ _

Enclosures

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.112 25. Form: Distribution Table

§13.112 25. Form: Distribution Table

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ESTATE OF MARY LEA SINGLE

ROY L. PAGE's Share	AMY LYNN SINGLE CHILD'S TRUST Tax ID# 68-1111112	TRAVIS DAN SINGLE CHILD'S TRUST Tax ID #68-1111113
SUMMARY	**SUMMARY**	**SUMMARY**
Outright to Roy L. Page	Sue N. Curtis is the trustee	Sue N. Curtis is the trustee
TRUST ASSETS	Not revocable or amendable	Not revocable or amendable
1. Lake Tahoe Condo	Amy receives all trust net income	Travis receives all trust net income
2. Vintage Bank CD ($99,000)	Principal for health and support	Principal for health and support
3. $1000 from Vintage Bank checking account	In existence until age 35	In existence until age 35
	Passes free of estate tax	Passes free of estate tax
	Annual fiduciary income tax returns	Annual fiduciary income tax returns
SUE N. CURTIS's Share	**TRUST ASSETS**	**TRUST ASSETS**
SUMMARY	1. ½ Personal Residence	1. ½ Personal Residence
Outright to Sue N. Curtis	2. ½ Time-Share	2. ½ Time-Share
TRUST ASSETS	3. ½ Edward Jones & Co. account	3. ½ Edward Jones & Co. account
1. Mobilehome	4. 272 shares of AT&T	4. 272 shares of AT&T
2. Totten Trust Account ($15,000)	5. 134 shares 3COM	5. 134 shares 3COM
	6. 174 shares Anheuser Busch	6. 174 shares Anheuser Busch
	7. $25,000 Treasury note	7. $25,000 Treasury note
	8. 15 shares Exxon	8. 15 shares Exxon
	9. Cash of $47,500	9. Cash of $47,500
	10. ½ Secured Note ($7500)	10. ½ Secured Note ($7,500)
	11. ½ Unsecured Note ($7500)	11. ½ Unsecured Note ($7,500)
	12. ½ interest in general partnership	12. ½ interest in general partnership
	13. ½ interest in sole proprietorship	13. ½ interest in sole proprietorship
	14. ½ proceeds of Allstate Annuity	14. ½ proceeds of Allstate Annuity
	15. ½ Lincoln Town Car	15. ½ Lincoln Town Car
	16. ½ Coin collection	16. ½ Coin collection
	17. ½ Napa Valley County Club Membership	17. ½ Napa Valley County Club Membership
	18. ½ Household effects	18. ½ Household effects

ESTATE OF MARY LEA SINGLE

ROY L. PAGE's Share	AMY LYNN SINGLE CHILD'S EXEMPT TRUST Tax ID# 68-1111112	AMY LYNN SINGLE CHILD'S NONEXEMPT TRUST Tax ID #68-1111114
SUMMARY Outright to Roy L. Page **TRUST ASSETS** 1. Lake Tahoe Condo 2. Vintage Bank CD ($99,000) 3. $1000 from Vintage Bank checking account	**SUMMARY** Sue N. Curtis is the trustee Not revocable or amendable Amy receives all trust net income Principal for health and support In existence until age 35 Passes free of estate tax Annual fiduciary income tax returns	**SUMMARY** Sue N. Curtis is the trustee Not revocable or amendable Travis receives all trust net income Principal for health and support In existence until age 35 Passes free of estate tax Annual fiduciary income tax returns
SUE N. CURTIS's Share **SUMMARY** Outright to Sue N. Curtis **TRUST ASSETS** 1. Mobilehome 2. Totten Trust Account ($15,000)	**TRUST ASSETS** 1. ½ Personal Residence 2. ½ Time-Share 3. ½ Edward Jones & Co. account 4. 272 shares of AT&T 5. 134 shares 3COM 6. 174 shares Anheuser Busch 7. $25,000 Treasury note 8. 15 shares Exxon 9. Cash of $5,000 10. ½ Secured Note ($7500) 11. ½ Unsecured Note ($7500) 12. ½ interest in general partnership 13. ½ interest in sole proprietorship 14. ½ Lincoln Town Car 15. ½ Coin collection 16. ½ Napa Valley County Club Membership 17. ½ Household effects	**TRUST ASSETS** 1. Cash of $10,000 2. ½ proceeds of Allstate Annuity

ESTATE OF MARY LEA SINGLE

ROY L. PAGE's Share	TRAVIS DAN SINGLE CHILD'S EXEMPT TRUST Tax ID# 68-1111113	TRAVIS DAN SINGLE CHILD'S NONEXEMPT TRUST Tax ID #68-1111115
SUMMARY Outright to Roy L. Page **TRUST ASSETS** 1. Lake Tahoe Condo 2. Vintage Bank CD ($99,000) 3. $1000 from Vintage Bank	**SUMMARY** Sue N. Curtis is the trustee Not revocable or amendable Amy receives all trust net income Principal for health and support	**SUMMARY** Sue N. Curtis is the trustee Not revocable or amendable Travis receives all trust net income Principal for health and support

checking account	In existence until age 35 Passes free of estate tax Annual fiduciary income tax returns	In existence until age 35 Passes free of estate tax Annual fiduciary income tax returns
SUE N. CURTIS's Share **SUMMARY** Outright to Sue N. Curtis **TRUST ASSETS** 1. Mobilehome 2. Totten Trust Account ($15,000)	**TRUST ASSETS** 1. ½ Personal Residence 2. ½ Time-Share 3. ½ Edward Jones & Co. account 4. 272 shares of AT&T 5. 134 shares 3COM 6. 174 shares Anheuser Busch 7. $25,000 Treasury note 8. 15 shares Exxon 9. Cash of $5,000 10. ½ Secured Note ($7500) 11. ½ Unsecured Note ($7500) 12. ½ interest in general partnership 13. ½ interest in sole proprietorship 14. ½ Lincoln Town Car 15. ½ Coin collection 16. ½ Napa Valley County Club Membership 17. ½ Household effects	**TRUST ASSETS** 1. Cash of $10,000 2. ½ proceeds of Allstate Annuity

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Source: Estate Planning/California Trust Administration/13 Administering Single-Person Trust After Settlor's Death/ §13.112A 26. Form: Grant Deed for Transferring Single-Settlor Trust Property to Child

§13.112A 26. Form: Grant Deed for Transferring Single-Settlor Trust Property to Child

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RECORDING REQUESTED BY AND WHEN RECORDED MAIL TO:

DAVID B. GAW
GAW, VAN MALE, SMITH,
MYERS & REYNOLDS
A Professional Law Corporation
1000 Main Street, 3rd Floor
Napa, California 94559

MAIL TAX STATEMENTS TO:

CLIENT _ _[*name*]_ _
Address _ _[*address*]_ _

_____
ABOVE THIS LINE FOR RECORDER'S USE ONLY

GRANT DEED

_ _[*Date*]_ _
_ _[*City*]_ _, **California** _ _[*ZIP Code*]_ _

Documentary Transfer Tax is $0.00.

A.P.N.: _____

The undersigned hereby declares that:

1. This transfer is made without consideration and is therefore exempt from Documentary Transfer Tax (California Revenue and Taxation Code §11911).

2. This transfer is a parent-child transfer under §63.1 (specifically, subdivision (c)(7) thereof) of the California Revenue and Taxation Code and does not constitute a "change in ownership" for property tax purposes.

NOW, THEREFORE, _ _[*name*]_ _, **Trustee of The** _ _[*name*]_ _ **Trust under Declaration of Trust dated** _ _[*date*]_ _, **hereby grants 50 percent to** _ _[*name of child*]_ _, **and 50 percent to** _ _[*name of child*]_ _, **as Tenants in Common, that certain real property, situated in the State of California, County of Napa, City of _____, and described as follows:**

Commonly known as: _ _[*Address*]_ _, **California**

Mail tax statements as directed above.

LEGAL DESCRIPTION

A.P.N. _____

Date: _ _[*date*]_ _

_____

_ _[*Name*]_ _, as Trustee of The _ _[*name*]_ _, under Declaration of Trust dated _ _[*date*]_ _

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF NAPA)
)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name of trustee*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

Comment: For an affidavit of successor trustee form, see §14.108.

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§13.113 27. Form: Closing Letter to CPA

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

Our File:

_ _[*Name*]_ _**, CPA**

_ _[*Name of firm*]_ _

_ _[*Address*]_ _

Re: The _ _[*name of trust*]_ _

Dear _ _[*name*]_ _**:**

We have now completed the administration of _ _[*name of trust*]_ _**. Allocation of all trust assets was made as of** _ _[*date*]_ _**, and all assets have been distributed from the trust to the subtrusts established under it in accordance with the plan of distribution that we reviewed with you.**

Enclosed are copies of the following documents:

1. Trust Asset Allocation Agreement

2. Chart showing the allocation of trust assets

3. Asset allocation spreadsheet showing the final allocation of assets

It is our understanding that your office has assumed responsibility for filing the state and federal fiduciary income tax returns for _ _[*name of trust*]_ _**, acting as an administrative trust. As we discussed,** _ _[*e.g., we will be reporting all administration expenses on Schedule J of the 706, and we understand you will not be deducting those expenses on the Trust's fiduciary income tax return*]_ _**.**

Finally, it is also our understanding that your office has assumed responsibility in the future for filing of annual state and federal fiduciary income tax returns for _ _[*e.g., each of the Children's Trusts established under The* _ _[*name*]_ _ *Family Trust*]_ _**. The TIN for each trust is shown on the enclosed chart.**

It has been a pleasure working with you during the administration of _ _[*name of trust*]_ _**. Your ideas and input were very much appreciated. We looking forward to working with you again in the near future. Please give us a call if you have any questions.**

Very truly yours,

__[*Signature*]__
_ _[*Typed name*]_ _

Enclosures

cc: _ _[*name of client*]_ _

_ _[*name of client*]_ _

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§13.114 28. Form: Sample Termination of Engagement Letter

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LAW OFFICES
GAW VAN MALE

_ _[*date*]_ _

Our File: CURTIS-1

SUE N. CURTIS

465 Stonehenge Drive

Napa, California 94558

ROY L. PAGE

1000 Hummingbird Lane

Napa, California 94558

Re: Conclusion of Family Trust Administration

Dear Ms. Curtis and Mr. Page:

The administration of The Single Family Trust ("Family Trust") has now come to a close. We are enclosing for your records a binder containing copies of each trust administration document that has been produced in the course of this administration. Also enclosed is a chart showing how the Family Trust was divided into separate trusts and summarizing the essential provisions of each trust.

The Family Trust will now cease to exist. However, as explained in this letter, Sue is the Trustee of the Children's Trusts established for Travis and Amy. Sue has the ongoing responsibility for the administration of these trusts.

You will recall that you signed a Trust Asset Allocation Agreement specifying the manner in which assets of the Family Trust are to be distributed. You also signed all transfer documents necessary to fund the separate trusts established under the Family Trust. We are processing the documents necessary to complete these transactions. Please note that the value of assets shown in the Date of Death column of the Asset Allocation Spreadsheet is the tax basis of those assets for purposes of the ongoing trusts.

We have prepared the federal estate tax return. As we have explained, there may be an audit of such return sometime within the next year.

As Trustee of each Child's Trust, Sue is required to file separate fiduciary income tax returns for those trusts. Your CPA has assumed responsibility for ongoing tax compliance work, including the preparation of fiduciary income tax returns for the various subtrusts, and we will write your CPA a confirmation letter to that effect.

As we discussed at our last meeting, Sue should open new checking accounts for each separate trust using the cash amounts shown in the distribution columns of the Allocation Spreadsheet and on the schedules to the Asset Allocation Agreement. These accounts should be opened under the tax identification number (TIN) assigned to each separate trust. These TINs are specified on the enclosed distribution chart. All income from

each trust should be deposited first to the appropriate checking account for that trust, and all expenses of that trust should be paid from that account. In this manner, your checking account records will serve as a transactional history for each separate trust. Keeping careful records of each trust's financial transactions is critical for tax and accounting purposes.

In summary, it is important to understand that Sue has an ongoing fiduciary responsibility for the administration of the various irrevocable trusts that have been established. Sue's fiduciary duties and responsibilities are discussed in detail in the Trust Administration Memorandum that we sent to you at the beginning of the administration process. We recommend that Sue reread that memo to refresh her memory.

It has been a pleasure working with you. To help us provide better service to our clients, we enclose a client survey. We appreciate your taking a couple of minutes to complete the survey and return it to our office in the enclosed self-addressed, stamped envelope.

We are a full-service law firm with attorneys practicing in a wide range of specialized areas of practice. Our services are not limited to trust administration, but encompass nearly all areas of the law, including estate planning, probate, civil litigation (including trust and estate disputes), family law, real estate, business planning, business sales and acquisitions, and contract law. If you have any questions, please give us a call.

Very truly yours,

GAW VAN MALE

DAVID B. GAW

Enclosures

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§13.115 29. Form: Client Survey

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CLIENT SURVEY

Name of client: _____

1. Name of attorney who represented you: _____

2. Why you chose our law firm to represent you (check as many as apply):

___ Referral from another lawyer **___ Referral from a friend**

___ Saw our ad in Yellow Pages **___ Former client**

___ Seminar **___ Other (please indicate):**

3. What type of case did we represent for you?

___ Business	**___ Civil Litigation**	**___ Conservatorship**
___ Corporation	**___ Criminal**	**___ Domestic Relations**
___ Probate	**___ Estate Planning**	**___ Pension/Profit Sharing**
___ Real Estate	**___ Personal Injury**	**___ Business Sales/ Acquisitions**
___ Tax	**___ Public Benefits/Medi-Cal**	
___ Development/ Land Use	**___ Trust Administration**	
___ Other	**___ Probate/Trust Litigation**	

4. How would you rate the overall quality of legal help you received?

___ Excellent ___ Good ___ Average ___ Poor

5. How would you rate the overall quality of our facilities:

___ Excellent ___ Good ___ Average ___ Poor

6. Please rate the following:

___ Excellent ___ Good ___ Average ___ Poor

Time spent in the waiting room for attorney to see you _____

How you were kept informed about progress of case _____

Promptness of lawyer and/or staff in returning your telephone calls _____

Reasonableness of fee charge _____

Satisfaction with results _____

Courtesy of office staff _____

Courtesy of lawyer _____

7. Would you recommend our firm to another person? _____
Why or why not? _____

8. Other comments: _____

THANK YOU FOR YOUR RESPONSE

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13A

Administering Moderate Married Settlor Trust on the Death of the First Spouse

David B. Gaw
James P. Lamping

I. WHEN NO TAX IS EXPECTED ON SECOND DEATH §13A.1
A. Similarities of Probate and Trust Administration §13A.2
B. System for Married Settlor Trust Administration §13A.3

II. ADMINISTRATION OF JOINT REVOCABLE TRUST §13A.4
A. Step One: Prepare for First Meeting
1. First Telephone Call §13A.5
2. Pre-Appointment Documents §13A.6
3. Review Trust Instrument §13A.7
a. Identify Subtrusts Established at First Death §13A.8
b. Watch for Second Marriage Situations §13A.9
c. Look for Subchapter S Issues §13A.10
d. Look for Limited Powers of Appointment §13A.11
e. Prorata or Nonprorata Distribution §13A.12
f. Disclaimer Opportunities §13A.13
g. "Administrative Trust" Clause §13A.14
h. Allocation Between Principal and Income §13A.15
i. Reporting and Accounting Clause §13A.16
j. Payment of Interest §13A.17
k. Annual Exclusion Gifts §13A.18
l. Trustee Provisions §13A.19
m. Asset Schedule §13A.20
n. Ambiguities and Drafting Errors §13A.21
o. Disqualified Persons §13A.22
p. Specific Gifts §13A.23
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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.1 I. WHEN NO TAX IS EXPECTED ON SECOND DEATH

§13A.1 I. WHEN NO TAX IS EXPECTED ON SECOND DEATH

This chapter addresses the legal and tax issues involved in administering a married settlor joint revocable trust on the first death when estate taxes are not anticipated on the death of the surviving spouse. With the possible exception of certain stale trust funding situations (see chap 14A), this scenario will typically result in the funding of only two trusts, regardless of whether the trust instrument has been drafted for a two- or three-trust division.

The resulting administration is less complex than the process required for a larger married settlor trust in which estate taxes are postponed until the second death by allocating a portion of the deceased spouse's share of trust property to a marital deduction qualifying trust to reduce the deceased settlor's taxable estate to an amount equal to the deceased settlor's remaining applicable exclusion amount. This process of marital deduction subtrust funding is described in detail in chap 14. In its level of complexity, the administration of a moderate married settlor trust more nearly resembles the single-settlor trust administration described in chap 13, simplified by the absence of an immediate estate tax liability.

Nevertheless, this chapter will dispel the common misconception that there is no need for professional services in the administration of revocable trusts after death, especially when there is only a moderate taxable estate. Trust administration requires structure and formality, with concomitant legal and accounting fees, even if there is a fully funded revocable trust in place. This misunderstanding may be the greatest myth of living trusts.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.2 A. Similarities of Probate and Trust Administration

§13A.2 A. Similarities of Probate and Trust Administration

In fact, probate and trust administration require the same three administrative functions: (1) making an inventory of assets, (2) paying debts and taxes, and (3) distributing the remaining assets to the designated beneficiaries. With a revocable trust, there is no probate court supervision and, therefore, no structure and formality. The absence of formal procedures can make trust administration more complex than probate. It is therefore incumbent on the professional team, primarily the attorney and the accountant, to impose formality where none exists.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.3 B. System for Married Settlor Trust Administration

§13A.3 B. System for Married Settlor Trust Administration

This chapter describes a system for administering married settlor trusts on the first death that includes: (1) procedural checklists for joint revocable trusts; (2) a case database with all pertinent information relating to the trust; (3) a system of forms for trust administration documents; (4) a calendar system to track critical dates; (5) an asset collection system; and (6) a trust administration document assembly system.

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§13A.4 II. ADMINISTRATION OF JOINT REVOCABLE TRUST

In California and other community property states, the typical estate plan for a married couple will include a single trust instrument creating a two-person revocable trust. In non-community property states, a single trust for a married couple may be used in an attempt to obtain a stepped-up basis at the first death by granting the first spouse to die a general power of appointment over the entire trust estate, although this technique is not widely used.

The two-person trust document will be more complicated than the single-settlor trust described in chap 13. Typically, the instrument will attempt to cover administration during three distinct time periods or stages: (1) while both settlors are alive, (2) during the "over life" of the surviving settlor, and (3) following the death of the surviving settlor. This chapter will focus on the administration process of getting from Stage (2) to Stage (3).

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A. Step One: Prepare for First Meeting

§13A.5 1. First Telephone Call

The handling of the first telephone call after the death of the first spouse is critical to the success of the trust administration. Often, the first contact following the death of a spouse will be a telephone call from a child rather than the surviving spouse. Remember who the client is and be careful in disclosing information. The attorney should exercise care in explaining too much about the trust administration process at this stage; hold that discussion for the first meeting. However, more than in a single-settlor trust administration, the surviving spouse and well-intentioned children will often engage in postmortem self-help by proceeding to transfer joint bank accounts and brokerage accounts, file life insurance and retirement benefit claims, and the like. The attorney should warn the surviving spouse (and children) to do nothing until after they have all had a chance to meet. Otherwise, valuable planning opportunities (*e.g.*, disclaimers) may be lost.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.6 2. Pre-Appointment Documents

§13A.6 2. Pre-Appointment Documents

After scheduling an appointment for the first meeting, the next step is to perform a preliminary conflicts check, as discussed in §13.3, and send pre-appointment documents to the prospective client. See §§13.83-13.84 for a sample pre-appointment letter and a list of documents the client should bring to the first meeting.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.7 3. Review Trust Instrument

§13A.7 3. Review Trust Instrument

The review of a married settlor trust instrument is similar to the process of review for a single-settlor trust described in §§13.4-13.18, with variations described in this chapter.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.8 a. Identify Subtrusts Established at First Death

§13A.8 a. Identify Subtrusts Established at First Death

In referring to subtrusts, this chapter uses the nomenclature adopted in chap 14 (survivor's trust, credit trust, marital trust, and disclaimer trust). The term "credit share" refers to the share of trust property not allocated to the survivor's share. The term "marital share" refers to a marital deduction qualifying gift, which could be allocated either to a marital trust or to a survivor's trust. See §§14.8-14.12A.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.9 b. Watch for Second Marriage Situations

§13A.9 b. Watch for Second Marriage Situations

In second marriage situations, the attorney should look for differences in distribution patterns depending on the order of death of the spouses. Watch for conflict of interest issues if the surviving spouse is the trustee of the administrative trust or subtrusts.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.10 c. Look for Subchapter S Issues

§13A.10 c. Look for Subchapter S Issues

If the trust may contain S corporation stock, consider whether the credit trust qualifies as a "qualified subchapter S trust" (QSST). A revocable trust will continue to qualify as an S corporation shareholder for only 2 years after the settlor's death. IRC §1361(c)(2)(A)(ii). If the credit trust "sprinkles" income, it does not qualify as a QSST, but the trustee may elect to treat it as an electing small business trust (ESBT). See §14.13.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.11 d. Look for Limited Powers of Appointment

§13A.11 d. Look for Limited Powers of Appointment

The attorney should look for provisions granting the surviving spouse a special or limited power of appointment over the credit trust. Such a power can be very useful in revising poorly drafted trust instruments, especially "trust mill" documents (which, unfortunately, only rarely contain special powers of appointment).

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§13A.12 e. Prorata or Nonprorata Distribution

The attorney should determine whether the trust instrument authorizes nonprorata distribution of trust assets, as permitted by the default rule in Prob C §16246, and whether this authority extends to nonprorata distribution of community property. See §14.58.

In the past, there was some concern that a nonprorata distribution of community property might be considered a taxable event by the IRS. The authorization contained in Prob C §§100-101 likely prevents this result; however, it does not necessarily follow that the trustee has unfettered power to allocate assets in whatever manner the trustee chooses. Notwithstanding that the trustee is given some discretion in this regard, the trustee still has the duty to exercise that discretion reasonably. Prob C §§16080-16081. When a nonprorata distribution arguably favors one beneficiary over another, the trustee may violate the duty to deal impartially with beneficiaries. Prob C §16003. This danger may be especially acute when the trustee is also a beneficiary. See §16.55. Representing a client as beneficiary and trustee may present challenges for the attorney as well. On representing a single individual client in the dual capacities of trustee and beneficiary, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel 52 (State Bar of California 2008 ed). See also §1.10.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.13 f. Disclaimer Opportunities

§13A.13 f. Disclaimer Opportunities

Disclaimers may serve a number of useful purposes, especially in the first death setting. Some uses of disclaimers include funding a disclaimer trust, such as passing the decedent's one-half interest in joint tenancy property (*e.g.*, bank accounts held outside the revocable trust) through the pourover will to the credit trust, passing assets through the credit trust down to the children at the first death, passing assets from a trust with a mandatory income interest to a "spray" trust, and eliminating a "bad" power or administrative provision. See §13.39.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.14 g. 'Administrative Trust' Clause

§13A.14 g. "Administrative Trust" Clause

The attorney should determine whether the trust instrument mandates the use of an administrative trust, as discussed in §§14.2-14.6. See also §13.10.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.15 h. Allocation Between Principal and Income

§13A.15 h. Allocation Between Principal and Income

The attorney should determine whether the trust instrument provides for allocation of receipts and disbursement between principal and income or whether the allocation will be made under the default rules contained in the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), as discussed in §§14.56A-14.56B. See also chap 8.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.16 i. Reporting and Accounting Clause

§13A.16 i. Reporting and Accounting Clause

The attorney should determine what, if anything, the trust instrument provides about accounting requirements during the lifetime of the surviving spouse. California law generally does not require an accounting except to persons currently entitled or authorized to receive distributions of trust income or principal, usually the surviving spouse. Prob C §16062. However, the trust instrument may contain different provisions concerning reporting. See Prob C §16061. Some drafters include provisions requiring the surviving spouse to account to children even if the children are not permissible beneficiaries of the trust until the death of the surviving spouse. Such a provision may be especially useful in second marriage situations where the settlors wanted some checks and balances on the survivor, yet desired the survivor to serve as sole trustee.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.17 j. Payment of Interest

§13A.17 j. Payment of Interest

The attorney should determine whether the trust instrument waives the requirement of interest on pecuniary gifts after 1 year under Prob C §16340(b), as discussed in §§13.15B, 14.44.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.18 k. Annual Exclusion Gifts

§13A.18 k. Annual Exclusion Gifts

The attorney should determine whether the trust instrument provides for IRC §2503(b) annual exclusion gifts and under what terms, as discussed in §13.15C.

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§13A.19 I. Trustee Provisions

The attorney should determine who is named as the successor trustee, and whether the same person is named as the executor of the pourover will. The attorney should also look for trustee compensation provisions (see chap 9) and trustee powers (see chap 2). On cotrustees and shared fiduciary powers, see chap 3.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.20 m. Asset Schedule

§13A.20 m. Asset Schedule

The attorney should review the asset schedule, if any, attached to the trust. The attorney should determine whether the assets listed on the schedule were properly transferred to the trust, as discussed in §13.18.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.21 n. Ambiguities and Drafting Errors

§13A.21 n. Ambiguities and Drafting Errors

The attorney should look for unclear or ambiguous provisions that may require interpretation or clarification by court order, as discussed in §13.17.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.22 o. Disqualified Persons

§13A.22 o. Disqualified Persons

The attorney should review the trust instrument to determine whether any beneficiaries are "disqualified persons" under Prob C §21350, as discussed in §13.16.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.23 p. Specific Gifts

§13A.23 p. Specific Gifts

The attorney should determine whether the trust provides for any specific gifts of property or cash, such as specific gifts to family members, including the surviving spouse, friends, or charities, at the first death.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.24 4. Review Pourover Will

§13A.24 4. Review Pourover Will

If a disclaimer trust plan is used, review the pourover will provisions carefully. If not properly drafted, a pourover will might inadvertently require a probate at the first death when there are assets outside the trust, as discussed in §13.19, even though the surviving spouse does not intend to disclaim to fund the credit trust.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.25 5. Review Other Documents

§13A.25 5. Review Other Documents

Review other estate planning documents, including irrevocable inter vivos trusts that were established by the deceased spouse or surviving spouse, such as irrevocable life insurance trusts.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.26 6. Prepare Trust Summary

§13A.26 6. Prepare Trust Summary

Summarize the terms of the trust and pourover will on a trust summary form for later reference, as discussed in §14.15A.

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§13A.27 B. Step Two: First Meeting With Client

Often the surviving settlor will be named the successor trustee. Combating the living trust myth in this situation can be an even greater challenge than in the single-settlor context. Emotionally, the surviving spouse is often reluctant to deal with issues. Lack of experience, especially when the deceased spouse handled the family finances, is often also a factor.

Even worse is the situation where the first death closely follows completion of the estate plan. The surviving spouse often is resentful that he or she has just paid a substantial fee to plan the estate and now faces additional fees to handle postdeath administration. No matter how much client education takes place at the estate planning stage, it is not unusual to hear comments like the following: "I don't understand why this is so difficult and expensive. I thought we got a living trust to avoid all this."

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§13A.28 1. Connect With the Client

It is essential to connect with the client at the first meeting, as discussed in §13.22. This is particularly the case when there has been a death of a spouse, which some psychologists have said is the most traumatic event anyone can experience. Consider that the surviving spouse may have been married for half a century. The surviving spouse may have little or no experience in financial matters because the deceased spouse was the principal financial person.

At the first meeting, the attorney's first words should not be a description of the trust administration process, but rather a showing of empathy for the surviving spouse. The attorney should explain what the grieving process is and how difficult it may be for the client. The attorney should also explain his or her feelings concerning the deceased spouse if the attorney knew the decedent. The prospective client must understand the process and know that the attorney cares about what the client is going through before they can begin to educate the client about the realities of trust administration, as discussed in §13.23.

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§13A.29 2. Breaking the Living Trust Myth

If the attorney did not prepare the estate plan, the client may believe the living trust myth that nothing needs to be done at the first death. This living trust myth is often more prevalent in a no-tax trust administration. In the case of a single-settlor trust, everyone recognizes that something has to be done, at least with respect to tax returns, if the settlor's taxable estate exceeds the applicable exclusion amount ($3.5 million in 2009). But if there is no estate tax, the client may believe that surely there is not much to be done in the trust administration.

On the contrary, the typical trust administration on the first death of a spouse can be the most complicated and difficult administration of all, with the largest number of potential pitfalls, which also means the greatest amount of possible planning. The conduct of the first meeting is critical in breaking the living trust myth.

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§13A.30 3. Identify Client and Determine Scope of Representation

If the surviving settlor is the trustee or co-trustee, particular care must be taken to define the scope of representation to avoid conflict of interest issues, *i.e.*, dual representation of the surviving settlor as trustee and beneficiary, as discussed in §13.21. On representing a single individual client in the dual capacities of trustee and beneficiary, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel 52 (State Bar of California 2008 ed). Theoretical conflicts can become real at certain stages, especially with respect to tax elections and subtrust funding.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.31 4. Documents Used at First Meeting

§13A.31 4. Documents Used at First Meeting

The following documents may be used at the first meeting.

- Two-Person Checklist. See §14.110.
- Client Conflict Information Request, given to client for completion. See §13.85.
- Authorization to Disclose Information. See §13.87.
- Beneficiary List, given to client for completion. See §13.88.
- Asset Collection Sheet, used to collect information at initial meeting, to track letters to institutions, and throughout the trust administration process. See §13.89.
- Instructions for Tracking and Paying Medical, Funeral, Administrative, and Personal Expenses, given to the client to explain the necessity of tracking various expenses during the administration process. See §13.91.
- Where to Put Receipts and From Where to Pay Expenses, guidance for the client regarding income and expenses during the administration; used at death of first settlor in joint revocable trust plan. See §14.25A.
- Time Sheet, used in the event a third party, rather than the surviving spouse, is acting as the successor trustee. See §13.93.
- Table of Trustee Duties. See §17.68.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.32 5. Educate Client About Trust Administration

§13A.32 5. Educate Client About Trust Administration

The client needs to understand the seriousness of his or her fiduciary responsibilities. The client should leave the first meeting with a working knowledge of the trust and his or her fiduciary duties, an outline of the steps involved in the administration process, and a list of actions steps. As part of the education process, compare probate and trust administration in terms of procedures, documentation, court supervision, and fees and expenses, as discussed in §13.23.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.33 6. Summarize Trust Provisions

§13A.33 6. Summarize Trust Provisions

Explain the trust instrument and present an overview of the distribution scheme, as discussed in §13.24. If there are continuing trusts, the trustee should understand the basic operation of those trusts and the scope of the trustee's discretion and authority in making distributions to those trusts, as discussed in §17.22.

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§13A.34 7. Collect Asset Information

The nature and extent of the decedent's assets, and title to those assets, must be determined as soon as possible. An initial inventory of assets should be prepared during the first meeting. Assets that require special attention should be identified as early as possible, as discussed in §§13.25-13.29. See form of asset collection sheet in §13.89.

In some cases, it may be difficult to determine whether a particular asset is properly characterized as community property, the separate property of one or the other spouse, or some combination of separate and community property. Moreover, the identification of property as community property on a schedule attached to the trust may be insufficient to transmute the property from separate property of one spouse to community property. See *Marriage of Starkman* (2005) 129 CA4th 659, 28 CR3d 639. See also *Marriage of Holtemann* (2008) 166 CA4th 1166, 83 CR3d 385, in which the husband agreed in writing that his property was "hereby transmuted" from his separate property to community property. For further discussion, see California Estate Planning §§4.39-4.39H (Cal CEB 2002).

As a practical matter, the characterization of property may not significantly affect the overall distribution of property, for example, in a long-term marriage with common children where the surviving spouse is extremely unlikely to remarry. However, in blended-family situations where litigation may be imminent, this issue can be hotly contested. See 1 California Decedent Estate Practice §§4.8-4.13 (2d ed Cal CEB 2009). See also California Trust and Probate Litigation §§18.41-18.46 (Cal CEB 1999).

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.35 8. Collect Liability Information

§13A.35 8. Collect Liability Information

Liability information should be collected, as discussed in §13.90. Determine the character of outstanding liabilities as community debts or separate debts of the deceased spouse and surviving spouse, respectively. Note that funeral and last illness expenses are chargeable solely to the deceased spouse. Prob C §19326. See §14.24. Identify contingent claims and determine whether the decedent was a defendant in any lawsuits pending at the time of death.

Discuss the liability of the trust for the decedent's debts. In California, the assets of a trust revocable by the settlor at death are subject to the claims of creditors and payment of expenses of administration if the estate is insufficient. Prob C §19001(a). See §10.2.

The attorney and client should consider and discuss the optional trust claims procedures in Prob C §§19000-19403. California law provides for a 1-year statute of limitations for actions against the decedent for which the statute of limitations has not run at the time of the decedent's death. CCP §366.2. The statute makes clear that it applies to claims against a revocable trust. Some practitioners believe that, because of this statute, the trust claims procedures are unnecessary; however, there may be a constitutional due process problem if actual notice is not sent to known creditors. *Tulsa Prof. Collection Servs., Inc. v Estate of Pope* (1988) 485 US 478, 99 L Ed 2d 565, 108 S Ct 1340. There are also potential equitable estoppel issues that could prevent enforcement of the 1-year limitation period. *Battuello v Battuello* (1998) 64 CA4th 842, 75 CR2d 548. See chap 10.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.36 9. Discuss Payment of Trust Expenses

§13A.36 9. Discuss Payment of Trust Expenses

Discuss whether the client has paid trust expenses. Frequently, the surviving spouse has paid funeral expenses, administration expenses, or other expenses that may be chargeable to the decedent's share of the trust out of his or her personal funds. See §§14.24-14.25A.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.37 10. Collect Beneficiary Information

§13A.37 10. Collect Beneficiary Information

Collect names, addresses, and social security numbers of all trust beneficiaries. This information will be needed for tax purposes, and for purposes of communicating with the beneficiaries concerning the administration of the trust. See form of beneficiary and heirs list in §13.88.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.38 11. Review Document List

§13A.38 11. Review Document List

Present the client with a list of documents to locate and deliver to the office, such as bank and brokerage account statements, certificates of title, income tax returns, partnership agreements, and corporate minute books. See form of information request in §13.84.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.39 12. Discuss Fiduciary Duties

§13A.39 12. Discuss Fiduciary Duties

Discuss the client's fiduciary duties as successor trustee under Prob C §§16000-16015, 16060, 16062, 16080, and 16200, and investment duties under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054), as discussed in §§13.31-13.34, 17.30-17.43. See also chap 5 on investment duties and chap 7 on reporting and accounting requirements. See §§8.11-8.15 on determination and distribution of income and principal.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.40 13. Discuss Trust Checking Account

§13A.40 13. Discuss Trust Checking Account

Advise the client to open a checking account for the administrative trust under the trust's taxpayer identification number (TIN) and determine the client's cash needs for personal expenses, as discussed in §13.34. Determine what expenses are properly chargeable to the trust, the amount paid, and the source of payment. Advise the trustee to request copies of receipts for such expenses and reimburse the person or persons who paid them. Give the client a list of examples of expenses to be paid from the trust checking account (see §13.92) and instructions for tracking and paying medical, administrative, and funeral expenses (see §13.91).

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§13A.41 14. Discuss Estate Tax Issues

The attorney and client should consider and discuss whether a marital trust must be funded and other steps that must be taken to avoid any estate tax on the first death. If the surviving spouse is not a United States citizen, the attorney may need to consider the application of the qualified domestic trust (QDOT) rules, but if the decedent's share is less than the decedent's remaining IRC §2010 estate tax applicable exclusion amount ($3.5 million in 2009) the marital trust will not be funded and no QDOT is necessary. If there is a possible estate tax, the attorney should identify property that passed to the decedent through a taxable estate within 10 years before death and so may qualify for an IRC §2013 prior transfer property (PTP) credit. See §12.51.

The attorney should also review lifetime gifts by the deceased spouse and determine whether any gift tax returns were ever filed. Determine whether gifts made by an agent under a durable power of attorney were authorized. See §13.4A.

NOTE: While there is some argument that a California Statutory Form Power of Attorney is not sufficient complete a valid gift for tax purposes, the author is aware of a legislative proposal to clarify that it does include this power. See Prob C §4401.

When a durable power of attorney does not authorize gifts, the gifts by the agent may be brought back into the estate. See Prob C §4264. Also determine whether gifts are incomplete. A gift by check that does not clear by the date of death may be incomplete, as discussed in §13.38. Identify assets that may be includable in the estate, as discussed in §13.35. Determine the need for state death tax returns in other states.

PRACTICE TIP: Warn the client not to rush to make distributions to beneficiaries. Making distributions too quickly might disrupt potential disclaimer planning because of the "acceptance of benefits" rule in IRC §2518(b)(3) (incorporated by reference in IRC §2046). See Treas Reg §25.2518-2(d) for a definition and examples of acceptance. See also Treas Reg §25.2518-3 on disclaimers of less than an entire interest. Be alert to conflicts of interest in advising beneficiaries on disclaimer planning issues. It is imperative to discuss the use of disclaimers with the surviving spouse at the earliest possible stage in the trust administration process, preferably at the first meeting.

Assuming that no estate tax will be paid on the first death and none is expected on the second death, the attorney should consider filing an estate tax return on the first death even if one is not required. If a Form 706 is filed, the value of an asset as reported on the return will create a presumption that the reported value is the asset's new basis for income tax purposes. Appraisals should be obtained to support the reported valuation. Under Treas Reg §1.1014-3(a), the appraised value of the property is "deemed" to be its fair market value, and it takes "clear and convincing evidence" to rebut this presumption. See, *e.g.*, Rev Rul 54-97, 1954-1 Cum Bull 113; *Swift v Wheatley* (3d Cir 1976) 538 F2d 1009; *Hess v U.S.* (Ct Cl 1976) 537 F2d 457.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.42 15. Discuss Income Tax Issues

§13A.42 15. Discuss Income Tax Issues

Determine who will prepare and file the decedent's final income tax return (or joint return with the surviving spouse) and the administrative trust's fiduciary income tax return. If probate is required because the trust was not fully funded, separate fiduciary returns may be required for the probate estate. Consider the need to refer the client to a certified public accountant (CPA).

Determine whether personal returns were filed for previous years as required, and determine whether any income tax returns are required in other states (*e.g.*, if there is income-producing property located in another state). Calculate the period for final (short-year) personal returns and the first short-year return for the trust. Determine whether a trust fiduciary income tax returns must be filed, depending on the amount of taxable income or gross income, as discussed in chap 12.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.43 a. Basis Step-Up (or Step-Down) on Trust Assets

§13A.43 a. Basis Step-Up (or Step-Down) on Trust Assets

Explain the basis step-up or step-down on trust assets under IRC §1014, as discussed in §7.30. The deceased spouse's separate property and all of the community property receive a 100-percent basis step-up or step-down to the date-of-death or alternate-valuation-date value, while the survivor's separate property receives no basis adjustment by reason of the decedent's death.

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§13A.44 b. Pass-Through Approach Versus Administrative Trust

Determine whether to use an administrative trust. In the author's experience, virtually all trust instruments are silent concerning postdeath administration. For those trusts, there are two camps: those who follow the "pass-through" approach and those who follow the "administrative trust" approach, as discussed in §§14.2-14.6.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.45 c. Nonprorata Allocation of Community Property

§13A.45 c. Nonprorata Allocation of Community Property

Discuss the income tax consequences of nonprorata allocation of community property to the various subtrusts. Most practitioners feel comfortable advising clients that a nonprorata allocation of community property is not a taxable event, while advising clients in writing of the possibility that the IRS may assert the contrary position, as discussed in §14.58.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.46 d. Simple Trust Versus Complex Trust

§13A.46 d. Simple Trust Versus Complex Trust

Discuss the difference in tax treatment and reporting requirements between "simple" trusts (all income is required to be distributed currently and only current income is distributed) and "complex" trusts (income may be accumulated by the terms of the trust or state law, or distributions are made other than from income) and timing of distributions to beneficiaries, as discussed in §§13.42-13.51.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.47 16. Discuss Real Property Tax Issues

§13A.47 16. Discuss Real Property Tax Issues

Discuss change in ownership of trust property for property tax purposes and applicable exclusions from reassessment, as discussed in §§13.52-13.53B.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.48 17. Trustee Compensation and Attorney Fees

§13A.48 17. Trustee Compensation and Attorney Fees

Discuss trustee compensation and attorney fees and billings, costs, retainer, and fee agreement, as discussed in §§13.54-13.56. See form of trustee time report in §13.93.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.49 18. Liquidity Analysis

§13A.49 18. Liquidity Analysis

Analyze liquidity needs for debts, taxes, and administration expenses, including attorney fees, trustee fees, and accounting fees, as discussed in §13.34. See form in §13.110.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.50 19. Stale Trust Issues

§13A.50 19. Stale Trust Issues

If the deceased spouse died several years earlier and no fiduciary returns have been filed or actions taken to fund the bypass trust, see discussion of "stale trust" issues in chap 14A.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.51 20. Calendar Next Meeting

§13A.51 20. Calendar Next Meeting

In the author's experience, it is important to calendar a follow-up meeting at the time of the first meeting so as not to lose momentum. Without the pressures of statutory and court deadlines, there is a tendency for trust administration files to languish.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.52 C. Step Three: Immediate Action Following First Meeting

§13A.52 C. Step Three: Immediate Action Following First Meeting

The following actions should be done immediately after the first meeting:

- Collect asset information (see §13A.53);
- Set up new case file (see §13A.56);
- Lodge pourover will (see §13A.57);
- Prepare Medi-Cal notice, certifications of trust, affidavit of death, and change in ownership forms (see §13A.58); and
- Send letters to beneficiaries and accountant (see §13A.59).

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.53 1. Collect Asset Information

§13A.53 1. Collect Asset Information

Carefully review the asset collection sheet (see §13A.34) filled out at the initial meeting. Determine what assets are in the trust, what assets are held outside the trust (either in the deceased spouse's name or in joint tenancy or some other form of joint ownership), and what assets are held in an unknown form of title. Send inquiries to financial institutions (see §13A.54) and instructions to brokers (see §13A.55) as needed.

When there is no information concerning assets, it is essential to immediately start collecting as much information as possible. See Handling Postmortem Trust Administration Checklist (Cal CEB Action Guide September 2009) for asset collection checklists for various kinds of assets.

Forms that may be used for this purpose include the following:

- Real estate. See §13.96.
- Traded securities, listed stocks. See §13.97.
- Traded securities, mutual funds. See §13.98.
- Traded securities, United States bonds. See §13.99.
- Other securities. See §13.100.
- Banks, savings and loan, and credit union accounts. See §13.101.
- Life insurance. See §13.102.
- Annuities, IRAs, and retirement plans. See §13.103.
- Promissory notes, mortgages, and deeds of trust. See §13.104.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.54 a. Letters to Financial Institutions

§13A.54 a. Letters to Financial Institutions

Prepare and send letters to financial institutions requesting cash account balances, date-of-death values of stocks, bonds, and mutual funds, and loan balances on all secured and unsecured loans. Request CUSIP numbers for all assets held by the broker. If the office uses an appraisal program (*i.e.*, Wallace or Appraise), insert the CUSIP number in the program to obtain future, past, or present values for stocks and bonds (mean, high, and low values for the specific date requested). For a sample form of letter to an insurance company, see §14.13B.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.55 b. Letters of Instructions to Brokers

§13A.55 b. Letters of Instructions to Brokers

Prepare and send letters to brokers requesting that brokerage accounts be transferred into the name of the successor trustee. Enclose a copy of the death certificate, certification of trust (the institution may require the trustee to execute its own form of certification), and taxpayer identification number (TIN) for the administrative trust.

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§13A.56 2. Set Up New Case Management Files

Set up new case management files and prepare and mail a fee agreement, as discussed in §13.58. Prepare a joint representation agreement as needed for co-trustees. Informed written consent is required if representation is joint. As part of the initial case set-up, calendar critical dates as discussed in §13.59. In the author's document assembly system for trust administration, once the date of death is entered in the program, it will automatically calendar most of the dates.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.57 3. Lodge Pourover Will

§13A.57 3. Lodge Pourover Will

Lodge the original pourover will with the county clerk and mail a copy of the will to the named executor as provided in Prob C §8200. See §13.60.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.58 4. Prepare Certifications, Notices, and Forms

§13A.58 4. Prepare Certifications, Notices, and Forms

Record a certification of trust in each county where real property is located. Consult local rules for peculiarities as to format. For a sample certification of trust, see §14.105. Prepare and send the Medi-Cal notice and other required notices, as discussed in §13.61. Prepare affidavit of death for the deceased spouse, as discussed in §13.62. See form of affidavit of death of trustee in §14.108. Prepare forms for the county assessor's office claiming exclusions from reassessment, as discussed in §13.63.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.59 5. Send Letters to Beneficiaries and Accountant

§13A.59 5. Send Letters to Beneficiaries and Accountant

Prepare and send information letters to beneficiaries, as discussed in §13.65. Prepare the CPA designation form and letter confirming the allocation of responsibilities, as discussed in §13.66. See forms in §§13.105-13.106.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.60 D. Step Four: Activities Following First Meeting (Second Stage)

§13A.60 D. Step Four: Activities Following First Meeting (Second Stage)

The process of collecting in-depth information concerning assets and liabilities of the trust estate must continue as quickly as possible. Enter known data into the asset allocation spreadsheet and fiduciary accounting program and update them as new information becomes available.

Some additional letters and forms that may be used include the following:

- Prepare and send a preliminary inventory of the trust estate to the client, as discussed in §13.67. See sample letter of instructions in §13.107.
- Order copies of deeds from the title company for all real property as discussed in §13.68.
- Order appraisals for all parcels of real property. Order appraisals for tangible personal property and business interests, and determine whether appraisals are required for intangible personal property, as discussed in §13.69. See form of letter to appraiser in §13.108.
- Prepare forms for the trust claims procedure, as discussed in §13.70.
- Request copies of gift tax returns, deliver stock certificates to brokers, and prepare letters regarding retirement benefits, as discussed in §13.71.

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§13A.61 E. Step Five: Activities Following First Meeting (Third Stage)

Prepare and send a detailed trust administration memorandum, prepare necessary documents to collect nontrust assets, and take necessary actions regarding closely held corporations, as discussed in §13.71. The memorandum essentially serves as a "case plan" for the administration. For a sample memorandum for a three-trust married settlor estate plan that may be adapted for a two-trust plan, see §14.15B. See substitute form language in §13A.84.

Determine whether court proceedings are necessary to collect assets or interpret the trust instrument, prepare appropriate court petitions, and commence proceedings. See sample petition for court approval of trustee actions and modification of trust in §14A.5.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.62 F. Step Six: Second Meeting With Client and Accountant

§13A.62 F. Step Six: Second Meeting With Client and Accountant

At the end of the first meeting, the attorney should have scheduled a follow-up meeting to review the client's progress and answer questions. The level of follow-up meetings required will depend on the complexity of the case and the sophistication of the client.

If the accountant was not present at the first meeting, encourage the accountant to attend the next meeting. Make sure the accountant has received the letter confirming the allocation of responsibilities, as discussed in §13A.58.

Verify that a trust checking account has been established, review client recordkeeping, and discuss progress on collection and appraisal of assets, as discussed in §13.72. Discuss possible sales of assets (see §13.73) and consider preliminary distributions (see §13.74).

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.63 G. Step Seven: Prepare for Final Distribution

§13A.63 G. Step Seven: Prepare for Final Distribution

Prepare for final distribution, as discussed in §§13.75-13.78. If further asset collection is necessary, it is essential that this be done before final distribution. Prepare transfer documents for funding distributions and send closing documents, as discussed in §§13.79-13.80.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.64 1. Determine Expense Deductions

§13A.64 1. Determine Expense Deductions

Determine deductions for administration and funeral expenses incurred. Funeral expenses may not be deducted, because they can only be deducted on the estate tax return, but administration expenses in a no-tax estate will be deducted on the income tax return. Expenses of decedent's last illness will be deducted on the decedent's final income tax return because there is no estate tax deduction in this fact pattern. Communicate these decisions to the accountant.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.65 2. Plan Asset Allocation

§13A.65 2. Plan Asset Allocation

Plan asset allocation among subtrusts. Consider possible income tax consequences of allocating community property on a nonprorata basis. Select the date when allocations will be made and the administrative trust deemed terminated. Select a date close in time to the date of actual distribution, *e.g.*, the last day of the preceding calendar month, and consider December 31 to avoid short taxable years and a multiplicity of income tax returns.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.66 3. Segregate Trust Assets

§13A.66 3. Segregate Trust Assets

Consider whether to use bookkeeping entries rather than actual transfers for asset allocations to successor subtrusts. The author believes the former method may be inconsistent with the trustee's duty to segregate trust assets. As a practical matter, financial institutions may require segregation of assets because the credit trust will have its own taxpayer identification number (TIN) that must be used for reporting purposes.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.67 4. Create Spreadsheet

§13A.67 4. Create Spreadsheet

The first step in implementing the subtrust funding is to create a spreadsheet. It is not possible to effectively allocate assets among the subtrusts without the use of a spreadsheet program. It is not important which program is used (*e.g.*, Quattro Pro, Louts 1-2-3, Excel); they all perform the same basic functions. The author uses Quattro Pro. The process of creating the spreadsheet is discussed in §14.14.

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III. ESTABLISHING TARGETS FOR ASSET ALLOCATION BETWEEN CREDIT AND SURVIVOR'S TRUST

§13A.68 A. Necessity of Targets

Even when an estate tax return will not be filed on the first death, it is imperative to establish the targets for funding the credit trust and survivor's trust, *i.e.*, the dollar value of the assets used to fund the trusts. Failure to properly determine the target amounts may result in the inclusion of a portion of the credit trust in the survivor's estate under IRC §2036(a). The credit trust also may be going to different beneficiaries than the survivor's trust, which could result in litigation between the competing beneficiaries. Though much less complicated than the process used for a marital trust division, as discussed in §§14.56C-14.56F, there is still a step-by-step process used in determining the target amounts in a credit-survivor's trust division.

In all cases, these steps include tracing transactions between the trust and the surviving spouse (see §13A.69) and making adjustments between the decedent's share and the survivor's share of the trust estate for expenses charged to the deceased spouse (see §13A.70). Further steps may include making adjustments between the credit trust and the survivor's trust for any marital deduction amount allocated to the survivor's trust (see §13A.71) and making adjustments for administration expenses deducted on the estate tax return (see §13A.72).

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.69 B. Tracing Transactions Between Trust and Surviving Spouse

§13A.69 B. Tracing Transactions Between Trust and Surviving Spouse

When the division is between the credit trust and the survivor's trust, it is necessary to trace transactions between the surviving spouse and the trust between the date of death and the date of allocation to make sure that trust expenses are properly allocated to the trust and the survivor's personal expenses are allocated to the surviving spouse, as discussed in §§14.19-14.26.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.70 C. Making Adjustments Between Deceased Spouse's and Surviving Spouse's Shares of Trust Estate

§13A.70 C. Making Adjustments Between Deceased Spouse's and Surviving Spouse's Shares of Trust Estate

The second step in determining the targets for the credit trust and the survivor's trust is to make adjustments between the deceased spouse's and surviving spouse's shares of the trust estate for expenses charged to the deceased spouse, as discussed in §14.27. Ordinarily, the deceased spouse's share is allocated entirely to the credit trust when there is no marital deduction amount and the survivor's share is allocated to the survivor's trust, as discussed in §13A.71.

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§13A.71 D. Making Adjustments Between Credit Trust and Survivor's Trust

A third set of adjustments may be needed between the credit trust and the survivor's trust after the survivor's share is allocated to the survivor's trust. In estate planning documents for a two-trust plan in which the marital deduction amount is allocated to the survivor's trust along with the survivor's share of trust property, the formula for dividing the trust between the credit trust and the survivor's trust usually will be either a pecuniary amount going to the credit trust, with the residual marital deduction amount going to the survivor's trust, or a pecuniary marital deduction amount going to the survivor's trust, with the residual amount going to the credit trust. The funding of assets in kind to satisfy the pecuniary amount may be based on date-of-death values or date-of-distribution values, as discussed in §§14.28-14.44.

NOTE: The result will typically be the same regardless of whether the instrument provides for a two-trust or three-trust division where only two trusts will be funded owing to the size of the estate. However, it may be possible to argue that a formula providing for a two-trust division should produce a different result in this circumstance. See discussion in §14A.26.

Assuming that the total value of trust assets on the date of death is less than the spouses' combined IRC §2010 applicable exclusion amounts ($7 million in 2009) and all of the trust assets are community property, then the target amount for both trusts will be the same unless the trust provides for additional unequal distributions to the survivor's trust. (Note that the trust cannot provide for unequal distributions to the credit trust because gifts by the surviving spouse are not protected by the marital deduction.) For example, if the total amount of community property in the trust was $4 million on the date of death, and this amount grew to $6 million between the date of death and the date of allocation, exactly $3 million will be allocated to each trust regardless of which formula is used because the marital deduction amount determined by the formula is zero. The result will be the same in a typical three-trust estate plan as described in chap 14, because the amount allocated to the marital trust will be zero and the deceased spouse's share of trust property will be allocated entirely to the credit trust. However, the conclusion that there is no difference in outcome between a two-trust and three-trust division may be subject to dispute, as discussed in §14A.26.

All separate property of the surviving spouse will be allocated to the survivor's trust and all separate property of the deceased spouse will be allocated to the credit trust, regardless of any appreciation or depreciation in the assets between the date of death and the date of distribution. Any substitution of community property for separate property could result in a realization of gain to the trust on appreciated property and no realization of loss on depreciated property under the related taxpayer rules in IRC §267, as discussed in §§11.48-11.50.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.72 E. Adjustment for Estate Tax Deductions

§13A.72 E. Adjustment for Estate Tax Deductions

The final adjustment in the target amounts is the deduction of certain expenses from the credit trust target (*i.e.,* funeral expenses, expenses of last illness, the deceased spouse's one-half share of any debt, and all administrative expenses) if those expenses have already been paid and were deducted on the estate tax return. An adjustment is needed because the estate tax deduction reduces the marital deduction amount allocated to the survivor's trust or the marital trust. If these expenses have not been paid, then they are paid from the credit trust. However, no further adjustment in the target amounts is needed if no estate tax return was filed, because these expenses were already taken into account in making adjustments between the deceased spouse's and surviving spouse's shares of the trust estate, as discussed in §13A.70.

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IV. ALLOCATING ASSETS BETWEEN CREDIT TRUST AND SURVIVOR'S TRUST

§13A.73 A. Appreciating Assets

Assuming the total trust estate is well below $3.5 million on the first death, and it is therefore likely that there will be no tax on the second death because the survivor's estate will be less than the applicable exclusion amount, appreciating assets probably should be assigned to the survivor's trust and not to the credit trust. Assets in the survivor's trust will receive a full step-up in basis on the second death and assets in the credit trust usually will not, unless the credit trust has been designed as a QTIPable bypass trust, as discussed in §14.12A.

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§13A.74 B. Family Residence

An interest in a personal residence allocated to the credit trust usually will not qualify for the exclusion of gain from the sale of a personal residence under IRC §121. See §14.59. A possible solution in this circumstance is for the surviving spouse to purchase the residence from the credit trust. See Lamping, *A House Divided: The Purchase by the Surviving Spouse of an Interest in the Family Residence Following its Allocation to Credit Trust*, 14 Cal Trusts & Estates Q 42 (Fall 2008).

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.75 C. S Corporation Stock

§13A.75 C. S Corporation Stock

A revocable trust will continue to qualify as an S corporation shareholder for 2 years following the settlor's death, but the credit trust may not qualify unless the trust contains language creating a qualified subchapter S trust (QSST) or electing small business trust (ESBT), as discussed in §14.13.

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§13A.76 D. Retirement Benefits

One of the most difficult issues in subtrust funding is dealing with retirement plan benefits, which are a major source of income in respect of a decedent. See §§14.62-14.65.

If the nonparticipant spouse dies first, and the spouses have a community property residence and the retirement plan but little other property, the question arises of whether there is a way to fund the credit trust with the nonparticipant spouse's community property interest in the survivor's retirement plan. A possible solution, at least for nonqualified plan benefits, might be for the trustee to make a nonprorata allocation of other assets to the credit trust, taking into account the deceased spouse's community property interest in the plan that "passes" to the surviving spouse outside the trust, as discussed in §14.58. For example, an additional $25,000 could be allocated to the credit trust in the moderate married settlor hypothetical to take account of Hank's community property interest in Wendy's IRA. See §13A.81. To facilitate this result, the attorney should check whether the trust specifically states that both spouses agree to the division of community property in the aggregate under Prob C §§100-101.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.77 E. Unmatured Life Insurance

§13A.77 E. Unmatured Life Insurance

If there is unmatured life insurance on the life of the surviving spouse or others, this property should generally be allocated to the credit trust. Otherwise, the proceeds might be taxable on the survivor's death in the unlikely event that the survivor has a taxable estate. See §12.34.

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§13A.78 F. Prepare Asset Allocation Agreement

Once an allocation has been determined, the attorney should prepare an allocation agreement setting forth the allocation of trust assets between the various subtrusts. See sample asset allocation agreement in §13A.82, based on the married settlor hypothetical in §13A.81.

Before the subtrusts are funded, it may be necessary to make an adjustment in the targets, and therefore in the assets distributed to the subtrusts, for expenses paid by the administrative trust, as discussed in §13A.72. However, no adjustment should be needed when no estate tax return is filed or a return is filed but no marital deduction or expense deductions are claimed on the return. In addition, the author prepares a table visually showing the allocation to the various subtrusts. See sample table in §13A.83, based on the married settlor hypothetical in §13A.81.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.79 G. Terminating Rather Than Funding Credit Trust

§13A.79 G. Terminating Rather Than Funding Credit Trust

In some cases, all relevant parties may agree that the credit trust may be more trouble than it is worth. While the author believes that it is a rare case where the credit trust will not provide at least some benefit for non-tax reasons, when the client is adamant that the credit trust should not be funded, the trustee must have the credit trust terminated by a court. For a discussion of the actions necessary to terminate a trust, see §17.65.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.80 V. STEPS FOR IMPLEMENTING SUBTRUST ALLOCATION AND COMPLETION OF ADMINISTRATION

§13A.80 V. STEPS FOR IMPLEMENTING SUBTRUST ALLOCATION AND COMPLETION OF ADMINISTRATION

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A. Prepare written schedule of assets for ongoing trusts.

- 1. Obtain TINs for ongoing irrevocable trusts.
- 2. Prepare certifications of trust for ongoing trusts.
- 3. Prepare diagram of distribution plan.
- 4. Send drafts of spreadsheet, asset schedules, and allocation table to client and CPA.
- 5. Consider review of distribution plan by beneficiaries.
- 6. Consider court approval of distribution plan.
- 7. Obtain trustee's and CPA's approval of distribution plan.

B. Prepare transfer documents for funding distributions.

- 1. Provide trustee with a letter or memo with written instructions on closing bank accounts and opening new accounts in the name of ongoing trusts, if any.
- 2. Prepare deeds and preliminary change of ownership reports (PCORs) for California real property. For out-of-state property, refer to attorney in other state for preparation of deeds and property tax declarations. See §14.109.
- 3. Prepare agreement for beneficiary to sign regarding assumption of mortgages on real property distributed.
- 4. Prepare assignment of leasehold interests and obtain landlord consent, if required.
- 5. Prepare and record assignment of notes and deeds of trust if trust owns notes secured by real property.
- 6. Prepare and file UCC-2 change statements with Secretary of State if trust owns notes secured by personal property.
- 7. Cancel old and issue new stock certificates for closely held corporations.
- 8. Review partnership agreements to ensure compliance with transfers of partnership interests, such as approval by other partners, and prepare assignments of partnership interests.
- 9. Prepare assignments of unsecured promissory notes.
- 10. Prepare and send letters to makers of notes advising them of the assignment and providing name and address of new holder for making future payments.
- 11. Prepare assignments of assets of sole proprietorship.
- 12. Prepare assignments of personal property.
- 13. Prepare forms to complete transfer of mobilehomes.
- 14. Prepare stock powers, affidavits of domicile, and letters of instruction for stock transfers.
- 15. Prepare letters to transfer agents or deliver certificates to broker for transfer.
- 16. Prepare letters of instructions to broker to transfer securities accounts.
- 17. Prepare letters of instructions to mutual fund companies for transfer of accounts.
- 18. Prepare transfer forms for treasury notes and bonds.
- 19. Prepare letters and forms for transferring U.S. savings bonds.

- 20. Complete transfers of vehicles (cars, boats, airplanes).
- 21. Prepare miscellaneous assignments for other assets.

C. Prepare waivers of accounting and obtain signed waivers from beneficiaries if formal accounting is required but not given under Prob C §16064. See §13.75.

D. Prepare beneficiary receipts for outright distributions.

E. Mail accounting, distribution checks/documents, and receipts by certified mail, if necessary.

F. Prepare letter of instructions to client re administration of ongoing trusts.

G. Prepare letter to CPA re ongoing trusts and allocation of responsibility for tax and accounting work. See §13A.85.

H. Send closing packet and termination letter to client.

I. Remind surviving spouse re funding of survivor's trust.

J. Send client satisfaction survey form to client. See §13.115.

K. Recommend changes to surviving spouse's estate plan. (Note: Items 4-7 may not apply if no estate tax is expected on the second death.)

- 1. Consider updating selection of fiduciaries.
- 2. Consider updating powers of attorney.
- 3. Consider amendments to survivor's trust.
- 4. Remind surviving spouse re annual exclusion gifts, if applicable.
- 5. Consider making gifts in excess of annual exclusion, if applicable.
- 6. Consider QPRT, GRAT, or other irrevocable trusts, if applicable.
- 7. Consider family limited partnerships or LLCs with children/irrevocable trusts.
- 8. Consider codicil or new will to exercise powers of appointment.
- 9. Consider need for life insurance and make referral.
- 10. Consider need for long-term care insurance and make referral.
- 11. Consider need for investment advice and make referral.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.81 VI. MODERATE MARRIED SETTLOR HYPOTHETICAL

§13A.81 VI. MODERATE MARRIED SETTLOR HYPOTHETICAL

Hank T. and Wendy M. Modest are married with two adult children, Michael D. Modest and Courtney A. Modest, both of whom are over age 30. Hank is a former doctor turned farmer and Wendy is a former nurse. They have an estate with a net worth of $2,320,000. Wendy has separate property valued at $250,000. They have assets with a value of $2,045,000 in the trust (the Modest Family Trust, a revocable trust) and assets with a value of $275,000 outside the trust. The estate consists of the following assets:

DESCRIPTION OF ASSETS	VALUE (DOD)
TRUST ASSETS	
COMMUNITY PROPERTY	
Personal residence, $500,000 gross value	$ 500,000
Orange grove	495,000
Promissory note secured by deed of trust from installment sale	75,000
Unsecured promissory note from loan to Michael	15,000
Savings account at The Vintage Bank	25,000
Franklin Tax-Exempt Fund	33,500
225 shares of Georgia Pacific	17,500
275 shares of Merck	29,750
400 shares of Home Depot	20,500
2016 shares of Fleetwood	223,750
2045 shares of National R.V. Holdings, Inc.	85,000
1730 shares of IBM	90,000
877 shares of ITT	50,000
388 shares of Mobil Oil	90,000
U.S. Savings Bonds	50,000
Hank's classic 1929 Model A	20,000
Household furniture and personal effects	25,000
SEPARATE PROPERTY	
Vacation home at Lake Tahoe (Wendy's separate property); no mortgage	250,000
TOTAL ASSETS IN TRUST	**2,045,000**
ASSETS OUTSIDE TRUST	
JOINT TENANCY	
Checking account at The Vintage Bank	$ 15,000
Dodge Ram	35,000
21-ft Sea Ray ski boat	15,000
OTHER	

Insurance policy on Hank's life	25,000
Hank's qualified retirement plans	135,000
Wendy's IRA account with Wells Fargo Bank	50,000
TOTAL ASSETS OUTSIDE TRUST	**275,000**
TOTAL NET ASSETS	**$2,320,000**

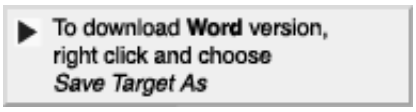
Hank died on November 1, 2009, and we are administering his estate. The revocable family trust provides for its division into three trusts (survivor's trust, marital trust, and credit trust) at the first death, using a "true worth" date-of-distribution pecuniary marital/residuary credit formula gift. The formula results in the allocation of the entire trust estate to the credit trust and the survivor's trust, with nothing allocated to the marital trust. At the second death, the children's share of the trust estate will be distributed to them outright. The trust provides that the residence and household effects are to be distributed to the survivor's trust.

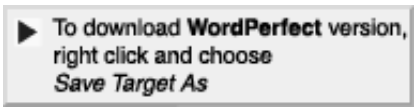
During administration, the stocks increased in value $200,000 but all other assets remained at the same value as on the date of death. Distribution to the subtrusts occurs 3 months after the death of Hank. The trust instrument does not waive interest on pecuniary gifts. Administration expenses totaling $10,000 are deducted on Form 1041. Note: The sample asset allocation agreement (see §13A.82) and allocation table (see §13A.83) based on the hypothetical assume that the credit trust does not reflect Hank's community property interest in Wendy's IRA.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.82 A. Form: Sample Trust Asset Allocation Agreement

§13A.82 A. Form: Sample Trust Asset Allocation Agreement





(Survivor's/Credit)

This Agreement is made as of February 1, 2010, by WENDY M. MODEST as Trustee of the MODEST FAMILY TRUST established under Declaration of Trust dated June 15, 1999 ("the Family Trust"), and as Trustee of the Survivor's Trust and Credit Trust established thereunder. WENDY M. MODEST shall be referred to in this Agreement as "the Trustee" or "the Survivor," as the context requires.

1. *Division of Family Trust Estate into Shares.* HANK T. MODEST ("Decedent"), died on November 1, 2009. The Trust provides that, on Decedent's death, the Trustee shall divide the Trust Estate of the Family Trust into three separate shares: a Survivor's Share, a Marital Share, and a Credit Share.

a. *Survivor's Share.* The Survivor's Share shall consist of (i) the Survivor's interest in the community estate, if any, in the Trust; (ii) the Survivor's separate property, if any, in the Trust; and (iii) if the Survivor survives the Decedent for thirty (30) days, the Decedent's interest in any Tangible Property of a Personal or Household Nature (as defined in Article Six of the Trust) in the Trust or transferred to the Trust by reason of the Decedent's death.

b. *Marital Share.* The Marital Share shall consist of the minimum dollar amount (if any) of the Decedent's interest in the Trust Estate necessary as a marital deduction to eliminate (or reduce to the extent possible) any federal estate tax by reason of the Decedent's death, taking into account all factors relevant to this estate tax objective. In determining this dollar amount, final federal estate tax values are to be used. All assets used to fund the Marital Share are to be valued as of the date or dates of distribution.

c. *Credit Share.* The Credit Share shall consist of the balance of the Trust Estate (*i.e.*, the balance of the Trust Estate not otherwise apportioned to the Survivor's Share and the Marital Share).

2. *Survival Requirements*. The Survivor has survived the Decedent for more than 30 days, and allocation of the Trust Estate shall be made as set forth above.

3. *Allocation of Expenses of Administration to Credit Share*. To date, the Trustee has incurred $10,000 of administration expenses, all of which have been paid and allocated to the Credit Share. All unpaid or contingent administration expenses or liabilities shall be charged exclusively to, and are hereby assumed by, the Credit Trust. The Trustee of the Credit Trust hereby agrees to reimburse the Family Trust and/or any other trust established under the Family Trust, as the case may be, for any expenses of administration paid by such trust or trusts that are properly chargeable to the Credit Trust. The Trustee of the Family Trust may (but shall not be required to) retain a reserve as part of the Family Trust for payment of unpaid or contingent expenses and liabilities as provided in paragraph 7 below.

4. *Funding of Trusts at Date-of-Distribution Values*. All assets allocated to the various trusts established under the terms of the Family Trust have been valued for purposes of such allocation at the date-of-distribution values.

5. *Calculation of Trust Estate Available for Distribution.* The total date-of-distribution value of the community property in the Trust Estate is $2,235,000. The Survivor's interest in the Trust Estate at date of distribution is $1,247,500. The Decedent's interest in the Trust Estate at date of distribution is $987,500. Of said amount, $0 constitutes the Marital Share, leaving the distribution value of the Credit Share at $987,500.

6. *Allocation of the Assets of the Family Trust Estate.* The Trustee hereby allocates the following items of property to the various trusts established under the Family Trust:

a. To WENDY M. MODEST, as Trustee of THE WENDY M. MODEST SURVIVOR'S TRUST, the property described in Schedule A attached to this Agreement and incorporated by reference, having a total value of $1,247,500 on the date of distribution.

b. To WENDY M. MODEST, as Trustee of THE HANK T. MODEST CREDIT TRUST, the property described in Schedule B attached to this Agreement and incorporated by reference, having a total value of $987,500 on the date of distribution.

7. *Interest on Pecuniary Gifts*. Under California law, a pecuniary gift bears interest if it is paid after one (1) year from the date of death of the Decedent unless such interest is waived. Because we funded the trusts within four months after the date of death and there was no pecuniary gift, this does not apply to you.

8. *Reserve for Contingent Liabilities.* Notwithstanding the provisions of paragraph 6 above, the Trustee may (but shall not be required to) retain as part of the Trust Estate of the Family Trust a reasonable reserve for unpaid and contingent administration expenses and liabilities chargeable to the Credit Trust hereunder for such period of time and in such amount as the Trustee, in the Trustee's sole discretion, determines. The balance of such reserve remaining after payment of all such charges shall be distributed to the Credit Trust.

9. *Further Documents.* The Trustee agrees to make, execute, and acknowledge such deeds, assignments, bills of sale, stock powers, letters of instruction, and other documents of transfer or conveyance as reasonably required to carry out the distributions set forth in paragraph 7 above and otherwise to carry out the terms of this Agreement.

10. *Indemnification*. The Trustee of each separate trust represented hereby agrees to indemnify, defend, and hold each and every other Trustee free and harmless from and against any and all liability, damages, losses, or expenses, including reasonable attorneys' and accountants' fees howsoever arising by reason of the distribution of the Trust Estate under this Agreement, including payment of taxes, interest, and penalties, if any.

11. *Binding on Successors.* This Agreement shall be binding on the heirs, successors, and assigns of the parties hereto, including any successor trustees of any of the trusts referred to herein.

12. *Governing Law.* This Agreement shall be governed by and construed in accordance with the laws of the State of California.

Executed at Napa, California, on February 1, 2010.

WENDY M. MODEST, as Trustee of the Family Trust, Credit Trust, and Survivor's Trust

SCHEDULE A
Assets Allocated to Survivor's Trust

Description	Net Value on Date of Death	Net Value on Date of Allocation
Personal residence	500,000.00	500,000.00
Vacation home	250,000.00	250,000.00
Orange Grove (62.12%)	307,500.00	307,500.00
Franklin tax-exempt fund	33,500.00	40,000.00
Savings account	25,000.00	15,000.00
Secured note	75,000.00	75,000.00
Unsecured note	15,000.00	15,000.00
Household effects	25,000.00	25,000.00
Classic car	20,000.00	20,000.00

TOTAL	1,251,000.00	1,247,500.00

SCHEDULE B
Assets Allocated to Credit Trust

Description	Net Value on Date of Death	Net Value on Date of Allocation
Orange grove (37.88%)	187,500.00	187,500.00
Merck stock	29,750.00	39,000.00
Home depot stock	20,500.00	40,500.00
Georgia Pacific stock	17,500.00	28,500.00
Fleetwood stock	223,750.00	250,000.00
Mobil Oil stock	90,000.00	147,000.00
National RV stock	85,000.00	80,000.00
IBM stock	90,000.00	140,000.00
ITT stock	50,000.00	75,000.00
TOTAL	794,000.00	987,500.00

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.83 B. Form: Table Showing Allocation to Various Subtrusts

§13A.83 B. Form: Table Showing Allocation to Various Subtrusts

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ESTATE OF HANK T. MODEST

THE HANK T. MODEST CREDIT TRUST Tax ID # 68-5764319	THE WENDY M. MODEST SURVIVOR'S TRUST Tax ID # 522-14-3702	WENDY M. MODEST'S NON-TRUST ASSETS Tax ID # 552-14-3702
SUMMARY Wendy M. Modest is the trustee Not revocable or amendable Wendy M. Modest receives all trust net income Principal for health, support and education In existence until Wendy M. Modest's death Passes free of estate tax Annual fiduciary income tax returns	**SUMMARY** Wendy M. Modest is the trustee Revocable and amendable by Wendy M. Modest Use income and principal as she wishes Included in Wendy M. Modest's taxable estate Income reported on personal tax return	**SUMMARY** Assets not held in any trust Probate may be required Included in Wendy M. Modest's taxable estate Income reported on personal tax return
TRUST ASSETS 1. 37.88% interest in orange grove 2. 225 shares Georgia Pacific 3. 275 shares Merck 4. 2016 shares of Fleetwood stock 5. 388 shares Mobil Oil 6. 400 sh Home Depot 7. 2045 sh National RV 8. 1730 shares IBM 9. 877 shares ITT	**TRUST ASSETS** 1. Personal Residence 2. Lake Tahoe vacation home 3. 62.12% interest in orange grove 4. Franklin Tax Exempt Fund 5. Savings account 6. Secured note 7. Unsecured note 8. Household effects 9. Classic car	**ASSETS** 1. Checking account ($5000) 2. Hank's qualified retirement plan 3. Wendy's IRA 4. Dodge Ram Dually 5. Sea Ray Ski Boat

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§13A.84 C. Form: Trust Administration Memorandum

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A. Division of the Family Trust in Separate Trusts

In your particular case, the Modest Family Trust was a joint revocable trust as long as Hank T. Modest and you were both alive. However, now that Hank T. Modest has passed away, the joint revocable trust must be divided into separate trusts. Until division, the Modest Family Trust will continue to operate as a single "administrative trust." After division, the Modest Family Trust will cease to exist.

At division, two separate trusts will be created: a "Credit Trust" and "Survivor's Trust." For sake of clarity, these will sometimes be referred to as the "Hank T. Modest Credit Trust" and the "Wendy M. Modest Survivor's Trust." In addition, the words "under Declaration of Trust dated June 15, 1999" should always be used following the words the "Credit Trust" or the "Survivor's Trust" for identification purposes.

The Survivor's Trust is a revocable, amendable trust which will include one-half of the community property and your separate property in the Modest Family Trust. The Credit Trust, in contrast to the Survivor's Trust, is an irrevocable trust which will contain the balance of the property of the Family Trust not allocated to the Survivor's Trust.

While both Hank and you were alive, you served jointly as Co-Trustees of the Family Trust. Now that Hank has died, you will serve as sole trustee of the Family Trust. As successor trustee, your responsibilities will include the collection of assets and gathering of information necessary to make the division into separate trusts. Once that division is completed, you will serve as successor trustee of the Credit Trust for as long as those trust exist or at least until you cease to serve as trustee and another trustee takes over.

Comment: This form may be used in place of the corresponding provision of the trust administration memorandum in §14.15B, as discussed in §13A.61.

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Source: Estate Planning/California Trust Administration/13A Administering Moderate Married Settlor Trust on the Death of the First Spouse/§13A.85 D. Form: Letter to CPA Confirming Responsibilities

§13A.85 D. Form: Letter to CPA Confirming Responsibilities

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

Our File No.:

_ _[*Name of CPA*]_ _
_ _[*Address*]_ _

Re: _ _[*e.g., The Modest Family Trust*]_ _

Dear _ _[*Name*]_ _**:**

We represent Wendy M. Modest, the successor trustee of the Modest Family Trust ("the Trust"). The purpose of this letter is to confirm our respective responsibilities for tax-related services in connection with the Trust and the Estate of Hank T. Modest, who died on October 1, 2009. Enclosed your records is a copy of the Modest Family Trust dated January 2, 1996.

We wish to confirm that you will be preparing the following tax returns on behalf of Wendy M. Modest:

1. Personal income tax return for Hank T. Modest and Wendy M. Modest for 2009 and for Wendy for 2010; and

2. Fiduciary income tax returns for the Trust, for each year during the period of the trust administration.

At this time, we do not anticipate filing an estate tax return for Hank's estate; however, we will know better once all the appraisals have come in for the real property.

It appears that the Trust was substantially funded and that no formal probate of the Will of Hank T. Modest is required. If assets outside the Trust otherwise subject to probate are found, these assets may be collected into the Trust using the Probate Code §13100 affidavit procedure, provided they have a total value less than $100,000. Should a formal probate be necessary, additional fiduciary returns for the probate estate may be needed unless an election is made to file only one fiduciary return and elect a fiscal year end for this return pursuant to Internal Revenue Code §645.

The Trust provides for division into two trusts on the death of Hank T. Modest, as follows: the Wendy M Modest Survivor's Trust and the Hank T Modest Credit Trust.

We have obtained the following taxpayer identification number for the Trust: 68-1234567. We have advised Wendy to establish a separate checking account for the Trust using the foregoing TIN and to pay all expenses and deposit all income relating to the Trust from and to this account.

Please also confirm whether you ever prepared any gift tax returns for Hank T. Modest. We would appreciate your sending us copies of all tax returns that you file on behalf of the decedent or the Trust so that we may keep our records up to date. We will do likewise.

In order to proceed, we need certain tax records which you may be able to supply:

1. Copies of all gift tax returns filed by Hank and Wendy, if any.

2. Copy of Hank and Wendy's most recent federal income tax return.

If the foregoing allocation of responsibility is not in accord with your understanding, please let us know. We strongly believe in working as a team with the CPA to complete the work necessary for trust administration. We appreciate your cooperation in this matter and look forward to working with you. Please call if you have any questions.

Very truly yours,

GAW VAN MALE

DAVID B. GAW

Enclosures

cc: Wendy M. Modest

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14

Subtrust Allocation and Funding on the Death of the First Spouse

David B. Gaw

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Y. Form: Completed Decedent and Surviving Spouse's Target Calculation Worksheet §14.104E
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XI. FORM: GRANT DEED FOR TRANSFERRING ASSETS OUT OF FAMILY TRUST §14.109

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.1 I. STEP-BY-STEP APPROACH TO TRUST ADMINISTRATION AND SUBTRUST FUNDING PROCESS

§14.1 I. STEP-BY-STEP APPROACH TO TRUST ADMINISTRATION AND SUBTRUST FUNDING PROCESS

This chapter focuses on postmortem trust administration for the surviving spouse, discussing the procedures for using an administrative trust and funding the subtrusts at the end of the trust administration period. For a comprehensive procedural checklist, see §14.110. For discussion of further steps to consider after the death of the first spouse, see chap 14A. For discussion of administering a moderate married settlor trust on the first death when no estate tax is expected on the second death, see chap 13A. For discussion of long-term trust administration, including the administration of credit and marital trusts, see chap 17.

NOTE: For these purposes, a surviving spouse does not include a same-sex surviving spouse or registered domestic partner treated as a surviving spouse under California law. This chapter describes how the decedent's share of trust property is allocated between the marital trust and the credit trust, based on the assumption that the amount allocated to the marital trust qualifies for the estate tax marital deduction under IRC §2056. Under the federal Defense of Marriage Act (1 USC §7), the term "surviving spouse" as used in IRC §2056 does not include a same-sex surviving spouse or registered domestic partner. Accordingly, a trust administration involving a deceased settlor with a same-sex spouse, like an administration involving a deceased settlor with a registered domestic partner, is more appropriately conducted as discussed in chap 13A.

The step-by-step approach covers the entire process, starting with outright distributions, and includes the following steps:

- Identify the subtrusts;
- Create a spreadsheet listing all assets;
- Establish targets for allocation and funding;
- Create a spreadsheet to determine targets;
- Allocate assets to the subtrusts;
- Select an allocation date;
- Prepare an asset allocation agreement and diagram;
- Follow a checklist for implementing the subtrust allocation; and
- Complete the trust administration by distributing the assets.

Some professionals view subtrust funding as an unimportant event that can be accomplished without a great deal of thought: "After all, at the first death we are in a nontaxable situation. Why is it so important what we do?" The answer is that a great deal of postmortem planning—including advance planning for trust administration on the second death—is possible if the potential consequences of the actions in subtrust funding are understood. Perhaps more importantly, improper subtrust funding may result in serious adverse tax and nontax consequences, including:

- Loss of S corporation election by not distributing within the prescribed period of time and/or distributing to a subtrust that does not qualify for the S corporation election;
- Loss of all or part of the marital deduction, resulting in estate tax;
- Immediate capital gains in funding particular types of pecuniary gifts;
- A possible immediate taxable gift by virtue of a transfer to an irrevocable trust;
- Potential taxation of part of the credit trust on the second death under IRC §2036(a);
- Acceleration of gain on funding an item of income in respect of decedent (IRD);
- Potential unintended carrying out of distributable net income (DNI) on funding of a pecuniary amount;
- Loss of all or part of IRC §121 for later sale of the personal residence through improper placement of a house in the wrong trust;
- Loss of all or part of the GST exemption;
- Failure to "pack" a credit trust by not using IRC §2032A;

- Failure to use discounts on funding at the first death;
- Loss of ability to take discounts on the second death;
- Unnecessarily losing step-up in basis on the second death for assets funded into the credit trust;
- An unhappy client if the surviving spouse becomes aware that opportunities were lost because of the way assets were allocated between trusts (*e.g.,* allocation of all the tax-free municipal bonds to the credit trust); and
- Discovery by trust beneficiaries that, as a result of an improper allocation of assets, a particular beneficiary did not receive the share he or she would have received had a proper allocation been made.

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§14.2 II. PASS-THROUGH ANALYSIS VERSUS ADMINISTRATIVE TRUST

Tax professionals debate the merits of using a separate taxpayer administrative trust from the death of the first spouse until the date of funding the subtrusts. Of course, if the trust instrument includes an administrative trust provision that deals with this issue, that instrument should be followed. Most trust instruments, however, do not require a postmortem administrative trust. For trusts that are silent, some practitioners follow the "pass-through" approach and some follow the "administrative trust" approach.

Under the pass-through analysis, the joint revocable trust ceases to exist at the date of death and should therefore be ignored for income tax purposes. All trust income is taxed to the survivor's, credit, and marital trusts, or other beneficiaries, respectively, commencing with the date of death, even though the trust estate has not been physically divided.

Other tax professionals suggest that a joint revocable trust functions like a probate estate and that the joint revocable trust, *i.e.*, an "administrative trust," should be treated as a separate taxpayer during the period between the date of death and the date the separate trusts are funded.

PRACTICE TIP: The IRS apparently has no stated position on this issue. But see Rev Rul 73-97, 1973-1 Cum Bull 404 (trustee's division of revocable trust into separate trusts on settlor's death constituted distribution for alternate valuation purposes, resulting in loss of right to determine value of property as of 6 months after death). Many of those who favor the pass-through approach justify their position by stating that they know of no adverse IRS response. This fact, however, may simply reflect a lack of personnel to audit fiduciary returns rather than an acceptance of this approach as technically correct.

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A. Arguments for Administrative Trust Approach

§14.3 1. Law of Trusts May Require Administrative Trust

The law of trusts is that a trust cannot exist without a "res" or property: A trust is created only if there is trust property. Prob C §15202. Therefore, arguably, until the various subtrusts are funded with at least some assets, no such subtrusts exist for which to file fiduciary returns, and an administrative trust is required.

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§14.4 2. Treasury Regulations Favor Administrative Trust Approach

The rules on when a trust is deemed to terminate for income tax purposes are set forth in Treas Reg §1.641(b)-3(b). That regulation provides that the determination of whether a trust has terminated depends on whether the trust property has been distributed to those entitled to it rather than on the technicality of whether the trustee has rendered a final accounting. A trust does not automatically terminate when a specific event occurs; instead, a reasonable time is permitted for the trustee to complete administration of the trust. That is, a trust continues for a period reasonably necessary to the "winding up" of its affairs. Treas Reg §1.641(b)-3(b).

The regulation lends support to the theory underlying an administrative trust, *i.e.*, it exists during the "winding up" period between the deceased spouse's date of death and its division into separate survivor's, credit, and marital trusts.

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§14.5 B. Practical Considerations for and Against Administrative Trust Approach

If the estate is not large or if funding is likely to occur fairly quickly, *i.e.,* certainly within the calendar year, many practitioners would not use the administrative trust approach. It adds costs and creates an extra administrative layer that may serve no useful purpose.

When the decedent's distribution plan includes multiple subtrusts (*e.g.*, credit trust and marital trust), however, it is more difficult to report income accurately using the pass-through approach because the funding decisions have not yet been made. If funding does not follow income as reported, all income-reporting entities will have to amend their returns. One alternative is to put all subtrust fiduciary returns and the surviving spouse's personal return on extension until the subtrust funding is complete.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.6 C. Tax Reporting for Administrative Trust

§14.6 C. Tax Reporting for Administrative Trust

If the administrative trust approach is used, a separate taxpayer identification number should be obtained for the joint revocable trust. For income tax purposes, income from trust assets during the administration period must be allocated between the administrative trust and the surviving spouse, based on their respective interests in the trust. Income from the deceased spouse's separate property is allocated to the administrative trust; income from the surviving spouse's separate property is allocated to the surviving spouse; income from community property is divided equally between the surviving spouse and the administrative trust. The surviving spouse reports his or her portion of the income on his or her individual tax return.

In essence, the administrative trust is treated as a "grantor trust" with respect to the surviving spouse's interest (IRC §§671-678) and as a "simple trust" or "complex trust" with respect to the balance (see IRC §§651, 661). A complex trust is (see definition of "simple trust" in Treas Reg §1.651(a)-1):

- Any trust in which all income is not required to be distributed;
- Any trust with charitable beneficiaries; and
- Any trust in which principal distributions are actually made during the taxable year.

For more on the definitions of simple and complex trusts, see §11.41.

California law permits a trust instrument to direct accumulation of income. CC §724. When the instrument is silent, there is case authority to support accumulation. See *Manning v Bank of Cal.* (1932) 216 C 629, 15 P2d 746; *Blackburn v Webb* (1901) 133 C 420, 65 P 952. Accordingly, absent any direction in the trust instrument, if all trust assets are community property, the deceased spouse's one-half share of the income is reported on the administrative trust's fiduciary return, and the administrative trust is treated as a complex trust for income tax purposes.

Regardless of the terms or the existence of a credit trust or a marital trust, however, if the trust instrument directs that all trust net income during the administrative trust period is payable to the surviving spouse and no principal distributions are made during the taxable year, the administrative trust may be a "simple trust." In the absence of such a direction, the administrative trust is a complex trust. The pecuniary formula gift to the credit trust or marital trust is a treated as a separate share that does not receive distributable net income (DNI) under IRC §663(c). See §11.46.

NOTE: Under Treas Reg §1.663(c)-4(b), applicable to estates and qualified revocable trusts, a pecuniary formula gift that is not entitled to income under the terms of the governing instrument or local law is a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments. Treas Reg §1.663(c)-5, Example 4. A pecuniary formula gift is not entitled to income but instead bears interest after 1 year under Prob C §12003. See §14.46. For further discussion, see Pennell, *Estate Tax Marital Deduction*, 843-2d, Tax Management Portfolios p A-132 (2005).

Separate employer identification numbers (TINs) are obtained for the credit trust and marital trust only when the administrative trust is terminated (see Treas Reg §1.641(b)-3(b)) and those trusts come into existence.

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III. INITIAL STEPS

§14.7 A. Make Outright Nonprorata Distributions From Trust

For outright distributions to beneficiaries, no taxable event occurs if the trustee has authority to distribute assets in kind on a nonprorata basis. If the trustee is not authorized to make nonprorata distributions, a taxable sale or exchange between beneficiaries may result. See Rev Rul 69-486, 1969-2 Cum Bull 159. In California, if the trust instrument is silent, the trustee has authority to distribute assets nonprorata. Prob C §16246.

A separate question is whether a taxable event occurs at the first death when a nonprorata allocation of community property is made between the subtrusts. Probate Code §16246 provides in part that a distribution in kind may be made under any written agreement that provides for a nonprorata division of the aggregate value of the community property assets. Probate Code §104.5 creates a presumption that spouses have agreed to an aggregate theory division of community property with respect to assets transferred to a revocable trust on or after January 1, 2000. This statute likely insulates nonprorata allocations of community property even in the absence of a separate agreement. See §14.58.

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§14.8 B. Identify Subtrusts to Be Funded at First Death

To create a spreadsheet and properly allocate assets between the subtrusts, the practitioner must understand what trusts (or shares) are established by the estate plan and which of these trusts or shares will actually be funded. This chapter uses the terms "survivor's trust" (see §14.9), "disclaimer trust" (see §14.10), "credit trust" (see §14.11), and "marital trust" (see §14.12) in referring to subtrusts. Some planners use a hybrid trust known as a QTIPable bypass trust. See §14.12A. A special form of trust may be needed to hold S corporation stock. See §14.13. The terms "bypass share" and "credit share" are used interchangeably. The term "marital share" refers to marital deduction qualifying gifts.

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§14.9 1. Survivor's Trust

"Survivor's trust" (or "A trust") is a common term for the trust that will specify the surviving spouse's interest in the trust estate, *i.e.*, the surviving spouse's half of the community property and the surviving spouse's separate property. The survivor's trust may include some of the deceased spouse's assets. Assets may be specifically given to this trust, such as the personal residence or tangible personal property. In addition, the marital share may be allocated either to a separate marital trust or to the survivor's trust. This trust remains revocable and amendable during the surviving spouse's lifetime.

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§14.10 2. Disclaimer Trust

A disclaimer trust is commonly used in optional bypass trust planning for small- to medium-size estates. Here, after the first death, the two-person revocable trust continues as a *single-person revocable trust,* known as the survivor's trust, except to the extent that the surviving spouse disclaims all or part of the deceased spouse's interest. The disclaimed portion of the deceased spouse's interest then passes to an irrevocable trust to absorb all or part of the deceased spouse's applicable credit amount. The drafter must make sure that the surviving spouse has no special power of appointment over the disclaimer trust and, if the surviving spouse is a trustee, no power to "spray" income to other beneficiaries; otherwise, the disclaimer will not be a "qualified disclaimer" under IRC §2518.

The disclaimer trust can be a disclaimer credit trust or a disclaimer marital trust, acting as a recipient of the disclaimed assets. For example, where the credit trust provides for income distribution only to the surviving spouse, a disclaimer credit trust might "sprinkle" or "spray" income to beneficiaries such as the spouse, children, and grandchildren. Use of a third party trustee for a disclaimer credit trust that includes such sprinkling powers is a way to avoid the potential conflict of interest that would exist if the surviving spouse acts as the trustee. See Drafting California Revocable Trusts, chap 14 (4th ed Cal CEB 2003).

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§14.11 3. Credit Trust

The credit trust (sometimes called the "B trust," "bypass trust," or "credit shelter trust") is the receptacle for the portion of the deceased spouse's estate that is subject to estate tax (*i.e.*, not qualified for the unlimited marital deduction), and is created to absorb the deceased spouse's applicable credit amount. This trust may also be called the "exemption" or "exemption equivalent trust," the "residuary trust," the "decedent's trust," the "family trust," and various other names. This trust may bypass the surviving spouse entirely in favor of the children, but in most married couple plans the trust continues for the benefit of the surviving spouse during his or her lifetime. The surviving spouse's interest in this trust might include mandatory, discretionary, or sprinkling income, principal distributions limited by an ascertainable standard, a "five or five" power, or other interests. If there is a sprinkling of income or a "five or five" power, there may be a Proposition 13 reappraisal of real estate allocated to this trust unless a disclaimer is used to eliminate the interest of a beneficiary who would cause a reappraisal. See §13.53. See also Drafting California Revocable Trusts, chap 14 (4th ed Cal CEB 2003).

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§14.12 4. Marital Trust

The marital trust (sometimes called the "C trust," "QTIP trust," or "marital deduction trust") is generally designed to qualify for the marital deduction and is usually the receptacle for the marital share. Depending on drafting, the marital trust may include only a portion of the marital share and the remaining amount may be given directly to the survivor's trust (*e.g.,* $100,000 may be given to the marital trust for purposes of making a "reverse QTIP election" if the decedent made lifetime taxable gifts of $100,000 over the amount of annual exclusion gifts that did not use any GST exemption). The attorney should verify that the marital trust actually qualifies for the marital deduction. If necessary, the attorney should consider commencing a court action to construe or reform a trust that may not qualify by its literal terms because, *e.g.*, the spousal gift is subject to a survivorship requirement of longer than 6 months. See §12.47.

Alternatively, the trust document may give the entire marital share to the survivor's trust, in which event there will be no marital trust. Several forms of marital deduction trusts exist, the most common being a QTIP trust under IRC §2056(b)(7). See Drafting California Revocable Trusts, chap 13 (4th ed Cal CEB 2003).

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§14.12A 5. QTIPable Bypass Trust

Some planners use a hybrid of a credit trust and a marital trust known as a QTIPable bypass trust that allows a QTIP election to be made for a larger portion of the decedent's share of trust property than is required to reduce the estate tax to zero. The purpose of the election is to obtain a second step-up in basis on assets included in the survivor's estate under IRC §2044 when it is unlikely that estate tax will be owed in the survivor's estate because of scheduled increases in the IRC §2010 estate tax applicable exclusion amount (AEA). The trust instrument gives the surviving spouse a qualifying income interest for life either for the portion of the credit trust for which the election is made or for the entire credit trust. When a QTIP trust will be created in any event, the objectives of a QTIPable bypass trust can be achieved by simply creating the QTIP trust and providing that a partial election will result in dividing the trust into two trusts.

EXAMPLE: Settlors create a revocable trust with $6 million in community property. On the first death in 2009, the decedent's share of the trust is allocated by formula entirely to a $3 million credit trust. The executor makes a partial QTIP election for one-sixth of the credit trust, resulting in the inclusion of $500,000 of the decedent's trust property in the estate of the survivor on the second death when the survivor's trust property is $3 million and the AEA is $3.5 million.

If the survivor's income interest is contingent on the executor making a QTIP election, an independent trustee may be used for this purpose to avoid any argument that the survivor has made a gift if the election is not made. Some practitioners believe that intentional as well as inadvertent elections may be disregarded under Rev Proc 2001-38, 2001-1 Cum Bull 1335. See §14A.14. For this reason, they recommend that the survivor disclaim a small portion of the marital trust so that a partial election for the credit trust is needed to reduce the estate tax to zero. In case the QTIP election is not made for a portion of the credit trust, the trust instrument may provide a mechanism for the survivor to disclaim the income interest in the trust to prevent the erosion of trust principal. The practitioner should be aware of these possibilities in the administration of a trust with features that allow the trustee to make a QTIP election larger than is needed to reduce the estate tax to zero. See Drafting California Revocable Trusts, chap 14 (4th ed Cal CEB 2003).

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§14.13 6. Subchapter S Trust

A revocable living trust will continue to qualify as an S corporation shareholder for up to 2 years following the settlor's death. IRC §1361(c)(2)(A)(ii). See §5.66. But see IRS Letter Ruling 200226031, allowing a trust with S corporation stock (which appears to have elected to be part of the "estate" under IRC §645) to continue to qualify as an eligible shareholder during the entire term of an IRC §6166 installment payment of taxes. A subtrust created on the death of the deceased spouse, however, may not qualify. If the credit trust provides for sprinkling of income, it cannot qualify as a "qualified subchapter S trust" (QSST), because a QSST is permitted only one income beneficiary during the life of the current income beneficiary. IRC §1361(d)(3)(A)(i). See also California Estate Planning §13.152 (Cal CEB 2002).

An "electing small business trust" may hold S corporation stock. IRC §1361(e). That section permits individuals to establish a trust for family members, which trust can "spray" income to family members. The drawback to an electing trust is that it is subject to a burdensome income tax. The portion of the trust consisting of S corporation stock is considered a separate trust that is not treated as a pass-through entity. The entire income of the separate trust is taxed at the maximum rates inside the trust and is not carried out in DNI. See IRC §641(c). See also Estate Plan §13.155.

Many trusts contain language creating a QSST in the event that the credit trust does not otherwise qualify as a QSST. The marital trust normally does qualify as a QSST.

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C. Sample Forms

§14.13A 1. Form: Sample Letter to IRS Regarding Extension of Time to File

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

Our File No.:

Internal Revenue Service Center
Cincinnati, OH 45999

Re: Estate of _ _[*Name*]_ _
Decedent's SSN: _ _[*SSN*]_ _
Application for Extension

Dear Sir or Madam:

Enclosed for filing are the following original forms:

1. IRS Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes.

2. IRS Form 2848, Power of Attorney and Declaration of Representative.

Also enclosed are four (4) quadruplicate copies of the Application.

The application requests a six-month extension of time to file the estate tax return/pay taxes, if any. The Power of Attorney requests that original documents be sent to this office, with a copy to Mrs. Rich.

Please acknowledge receipt of the enclosed Application by date stamping two (2) of the copies and returning them to this office in the enclosed self-addressed stamped envelope. If you have questions, please call me at _ _[*telephone number*]_ _**. Thank you for your assistance.**

Sincerely,

__[*Signature*]__
_ _[*Typed name*]_ _

Enclosures

cc: Wendy M. Rich

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.13B 2. Form: Sample Letter to Insurance Company

§14.13B 2. Form: Sample Letter to Insurance Company

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

Our File No.:

_ _[*Name of Insurance Company*]_ _
_ _[*Address*]_ _

Re: Estate of _ _[*Name*]_ _, _ _[*e.g., The Rich Family Trust*]_ _
Policy No.: _ _[*number*]_ _

Dear Sir or Madam:

We represent Wendy M. Rich, surviving spouse and successor trustee of The Rich Family Trust, a living trust established by Hank T. Rich and Wendy M. Rich under Declaration of Trust dated June 15, 1999. Hank T. Rich died on January 1, 2009.

For federal estate tax purposes, we will need the value of the above-referenced policy on the life of Wendy M. Rich as of January 1, 2009. In addition, we will need a copy of the current beneficiary designation for this policy. We are enclosing an authorization form which allows you to release this information to us.

Sincerely,

__[*Signature*]__
_ _[*Typed name*]_ _

Enclosures

cc: Wendy M. Rich

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§14.13C 3. Form: Sample Letter to Beneficiary

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

Our File No.:

_ _[*Name of Beneficiary*]_ _
_ _[*Address*]_ _

Re: _ _[*e.g., The Rich Family Trust*]_ _

Dear _ _[*name*]_ _**:**

Please accept our condolences on the death of your father. As part of your parents' estate plan, they established a living trust called The Rich Family Trust ("the Trust"). Your mother has hired this Firm to represent her, as successor trustee of the Trust. The purpose of this letter is to make you aware of the existence of the Trust and explain briefly the process of trust administration that will be undertaken by your with our assistance. Also enclosed is the notice required under Probate Code Section 16061.7.

The purpose of the Trust was to avoid probate. This purpose was accomplished to the extent assets were funded into the Trust before death. Probate is a court-supervised procedure for administering a person's property and affairs after death. Probate tends to be slow and expensive. Administration of a living trust after death is usually, though not always, less expensive and faster than probate.

Both probate and trust administration encompass the same three functions:

(1) Making an inventory of the decedent's assets;

(2) Paying all debts and taxes which are due; and

(3) Distributing the assets remaining after payment of debts and taxes in accordance with the decedent's instructions.

In a trust administration, this process may take anywhere from a several weeks to several years, depending on the size of the estate, the nature of the assets, the number of creditors or the existence of contested claims, the complexity of the tax issues involved, whether assets have to be sold in order to pay taxes or creditors, or to make distributions, etc. We anticipate your father's trust administration to last at least nine months, but portions of it may not be completed for upwards of 2 years.

In this particular case, the Trust will be divided into several shares as a result of your father's death:

The "Survivor's Share" consists of your mother's property in the Trust and will be distributed to a separate "Survivor's Trust" that will remain revocable and amendable by her.

The "Marital Deduction Share" consists of a formula amount of your father's property in the Trust necessary as a marital deduction to eliminate estate taxes as a result of your father's death. The Marital Deduction Share will be distributed to a separate, irrevocable Marital Trust.

The "Credit Share" consists of the balance of your father's property in the Trust, which will pass to a

separate, irrevocable trust known as the "Credit Trust."

Because the Survivor's Trust remains revocable and amendable by your mother, you have no rights therein as long as your mother is alive. However, because the Marital Trust and the Credit Trust are irrevocable, you have the right to request information with respect thereto upon reasonable request.

Your rights to the Marital Trust and the Credit Trust are subject to your mother's life interest. Your mother also has a special power of appointment over the Marital Trust and the Credit Trust by which your mother may change the distributions among the beneficiaries at her death, including the power to disinherit any one or more beneficiaries entirely.

Your mother, Wendy, is named as the sole successor trustee of the Trust and all the separate subtrusts established thereunder, except you will be acting as a special trustee with your mother for the Credit Trust, with the sole authority with your mother to determine who receives income from the Credit Trust. You should note that the Trust specifically provides that the interest of your mother to this income is superior to the rights of any other beneficiaries. As Trustee, your mother, except as provided above, has the sole authority to manage the Trust and subtrusts, make investment decisions, distribute property from the Trust, or otherwise deal with the trust property. The Trustee is also responsible for keeping financial records and filing income tax returns for the Trust.

The fact that you have an interest in the Trust may impact your own estate planning. For example, one useful estate planning device is called a "disclaimer." A disclaimer is a means by which you can renounce your interest in property or a trust in order to have that property pass as if you were already deceased.

You might ask why someone would do this. One very good reason is estate tax planning. For example, if you already have an estate for which you expect to pay death taxes, any additional property you receive will be subject to estate tax on your death (subject to your right to defer taxes until the death of your spouse if you are married and your estate is properly planned). However, if you disclaim an interest in property, that property is not subject to estate taxes in your estate because it is treated as if you never owned it.

If disclaiming an interest would cause that interest to pass to persons you would otherwise leave your property to anyway (your children, for example) it might make sense to execute a disclaimer, thereby allowing the property to pass to such persons free of estate taxes.

The reason we raise this issue now is that the Internal Revenue Code requires that a disclaimer of an interest be made within nine (9) months from the date of death of the person who created the interest, *i.e.*, in this case no later than October 1, 2006. The tax savings can be substantial. However, whether a disclaimer makes sense for you depends on the facts of your particular situation. If you would like to take advantage of this planning opportunity, you should discuss the matter with a competent estate planning attorney.

Please remember that we represent only the Trustee. We do not represent "the Trust" nor you individually. Nor will we represent individually if _ _[*name*]_ _'s interests as beneficiary are in a conflict of interest with the Trust. Thus, we cannot give you legal advice concerning your interests as a beneficiary.

Thus, if you have any questions general concerning your rights and interests with respect to the Trust, please consult with your own attorney.

Sincerely,

__[*Signature*]__
_ _[*Typed name*]_ _

cc: Mrs. Wendy M. Rich

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.13D 4. Form: Sample Letter to CPA Requesting Information

§14.13D 4. Form: Sample Letter to CPA Requesting Information

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_ _[*Letterhead*]_ _

_ _[*Date*]_ _

Our File No.:

_ _[*Name of CPA*]_ _
_ _[*Address*]_ _

Re: _ _[*e.g., The Rich Family Trust*]_ _

Dear _ _[*Name*]_ _**:**

We represent Wendy M. Rich as sole successor trustee of The Rich Family Trust. The purpose of this letter is to confirm our respective responsibilities for tax and legal services in connection with the Estate of Hank T. Rich, as discussed in our recent telephone conversation. Enclosed for your records is a copy of The Rich Family Trust dated June 15, 1999.

As a result of Hank's death, the Rich Family Trust provides for division death into three shares, a Survivor's Share, a Marital Share, and a Credit Share.

The Survivor's Share will be distributed to a Survivor's Trust that will be revocable and amendable by Wendy.

The Marital Share will be distributed to a Marital Trust for which we expect to make a QTIP election. The Marital Share is determined by a pecuniary formula which fixes the value of the Marital Share as of the date of death and is designed to result in zero death taxes as a result of Hank's death by taking advantage of the unlimited marital deduction. If the Marital Share exceeds the amount of Hank's unused GST exemption (after first allocating that exemption to the Credit Trust), the Marital Trust will be divided into two trusts: an Exempt Marital Trust (for which a "reverse QTIP election" will be made), and a Non-Exempt Marital Trust. Since Hank gifted assets valued at $240,000 prior to his death, thereby reducing his applicable exclusion amount from $3.5 million to $3.26 million (but retaining his full $3.5 million GST exemption), we anticipate that the Marital Trust will be divided into two such Marital Trusts. Please note that the funding of assets in kind into the Marital Share will be a taxable event for federal income tax purposes.

The Credit Share will be distributed to the Credit Trust; however, any assets that are received into the Credit Share by disclaimer will be allocated to a separate Disclaimer Credit Trust and any S corporation stock allocated to the Credit Share will be allocated to a separate S corporation Credit Trust.

Until such time as we have obtained all information necessary to file the Federal Estate Tax Return and divide the Family Trust Estate, the Rich Family Trust will continue to operate as a single "administrative trust." During this period between date of death and the funding of the separate trusts, the income from Trust assets should be allocated equally between Wendy (to be eventually reported on her 2009 individual return), and The Rich Family Trust (to be reported on a fiduciary income tax return filed for that trust).

As you are aware, there are various deductions that we can take on the fiduciary tax return (Form 1041), Hank and Wendy's last personal income tax return (Form 1040), or on the federal estate tax return (Form 706). Expenses of last illness as of the date of the death paid within 1 year of such date may be deducted on the 706 or the 1040 return (or partly on one return and partly on the other return), while funeral expenses may only be

deducted on the 706 return. The administration expenses may be deducted on the 706 or the 1041, or partly on one and partly on the other return. Where the deduction is taken will affect the target of the various subtrusts, that is, the dollar amount that will go into the various subtrusts, and it is imperative that your firm and my firm work together to coordinate the taking of deductions. Further, in respect to administration expenses, we may want to take them on the 1041 and pay the expenses out of Trust income during administration, which is discussed below.

Under Probate Code §16340(c)(2), a trustee may pay administration expenses out of trust accounting income, as long as such payment does not cause the reduction or loss of the marital deduction. For this reason, it is essential that the trustee determine not only Trust taxable income, but Trust accounting income during the period of administration. Under federal regulations, administration expenses are divided into "estate transmission expenses" and "estate management expenses." Treas Reg §20.2056(b)-4(d).

Estate transmission expenses are expenses that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and estate taxes, and distributing the decedent's property to those who are entitled to receive it. Estate transmission expenses include any administration expense that is not a management expense.

Estate management expenses are expenses incurred for investment, preservation, and maintenance of estate assets during a reasonable period of administration. Accounting, legal, and other professional fees may fall into both categories, depending on the nature of the services.

Transmission expenses that are claimed as estate tax deductions will in effect be charged against the marital share, but if claimed on the 1041, they must be charged against the credit share or the marital deduction will be reduced and an estate tax incurred. However, if there is a pecuniary marital gift and the marital share does not receive income under the state law, then payment of either transmission or management expenses out of income will not reduce the marital deduction, even if the expenses are claimed on the 1041. Treas Reg §20.2056(b)-4(d)(5), Example 7. Both California law and the formula used in Hank and Wendy's Trust meet the requirements of this Regulation.

Based on the foregoing, when we reach the stage for distribution into the subtrusts, it is essential that we know the Trust accounting income for Hank's side of the assets, plus any distributions of that income to Wendy. With this number, we can then decide how much of the administration expenses should be paid out of income.

After the division of the Rich Family Trust into separate trusts, the Rich Family Trust will no longer exist and fiduciary returns will be required annually for the various subtrusts established thereunder, although income from the Survivor's Trust income will continue to be reported on Wendy's personal returns. If we fund the separate trusts on December 31, 2009, there will be no short-year returns required. If, however, we fund on a date other than December 31, 2009, short-year returns will be required for the respective trusts (from the date of distribution until December 31, 2010), and the income will have to be apportioned.

Under Treasury Regulation §1.645-1, if there is an executor, the following steps must be taken. The trustee of the trust and the executor of the estate must make an election to treat the trust as part of the estate. This is done by the trustee and executor filing Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." For the election to be valid, the election must be filed no later than the time prescribed under Internal Revenue Code §6072 for filing Form 1041 for the first taxable year of the combined electing trust and related estate. The executor must file a complete 1041 for the combined estate and trust for each taxable year during the election period. The trustee must provide the executor with all trust information necessary to enable the executor to file the 1041.

If there is no executor (which will probably be the case in this administration), the following steps must be taken. The trustee must make the election by filing Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." The election must be made by the time prescribed for filing Form 1041 for the first taxable year of the electing trust. It is our understanding that you will prepare all personal, fiduciary, and corporate income tax returns. We will prepare the Federal and California Estate Tax Returns. It is also our understanding that you will assist Wendy in maintaining separate bookkeeping records for the Trust. If this allocation of responsibility for tax and accounting work is not in accord with your understanding, please let us know.

In order to proceed, we need certain tax records which you may be able to supply:

1. Copies of all gift tax returns filed by Hank and Wendy, if any.

2. Copy of Hank and Wendy's most recent federal income tax return.

3. Copy of the most recent corporate income tax return for Rich-Pack, Inc.

We strongly believe in working as a team with the CPA to complete the work necessary for trust administration. We look forward to working with you. Please call if you have any questions.

Sincerely,

__[*Signature*]__
_ _[*Typed name*]_ _

cc: Wendy M. Rich

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IV. SUBTRUST FUNDING: STEP-BY-STEP METHOD

§14.14 A. Create Spreadsheet and List All Assets

The first step in subtrust funding is to create a spreadsheet. It is virtually impossible to allocate assets effectively among the subtrusts without using a spreadsheet. It is not important which program is used; for example, Quattro Pro, Lotus 1-2-3, and Excel all perform the same basic functions. The exhibits to this chapter (see §§14.85-14.104F) were created on Excel.

In the first column of the spreadsheet, list all assets in the trust and outside the trust as of the date of death, their character as separate property, community property with right of survivorship, or community property, and whether there are any joint tenancy assets. Ascertain which assets are passing outside the trust and list them.

NOTE: It is helpful to list the assets in the same order as they appear on the federal estate tax return.

Because assets are often sold or transferred during the administration, identify which assets remain in the trust as of the allocation date and whether any assets were added to the trust that should have remained outside the trust. Ascertain whether assets are husband's separate property (HSP), wife's separate property (WSP), their community property (CP), held in joint tenancy (JT), or as community property with right of survivorship (CP w RoS).

In Exhibit A (see §14.85), all assets of each type are listed in one column with separate totals at the bottom of the column. It is usually preferable to create separate columns on the spreadsheet in this manner for each spouse's separate property, community property, joint tenancy property, and community property with right of survivorship, although doing so produces a spreadsheet wider than 8½ x 11. In Exhibits B through S (see §§14.86-14.103), by contrast, the property is not broken out into separate columns by type. Exhibit T (see §14.104) shows the allocation of assets to various subtrusts in tabular, rather than spreadsheet, form. In Exhibits U through Z (see §§14.104A-14.104F), the decedent's share of trust property is derived by disregarding nontrust property and subtracting each spouse's separate property from total trust property, then adding the decedent's separate property to the decedent's one-half share of community property.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.15 B. Married Couple Hypothetical

§14.15 B. Married Couple Hypothetical

For purposes of illustrating the use of spreadsheets, the following facts will be assumed in filling in the spreadsheets shown in the Exhibits accompanying this chapter:

Hank T. and Wendy M. Rich are married with two adult children, Michael D. Rich and Courtney A. Rich, both of whom are over age 30. Hank is a former doctor turned developer and Wendy is a former nurse. (Michael previously worked in the business and in 1996 Wendy and Hank made a gift to Michael of a 20-percent interest in commercial real property; it was then valued at $500,000 and is valued today at $2,000,000.) Their estate has a net worth of $10,025,000. Wendy has separate property valued at $250,000. They have assets with a value of $9,750,000 in the trust (the Rich Family Trust, a revocable trust) and assets with a value of $275,000 outside the trust. The estate consists of the following assets:

DESCRIPTION OF ASSETS	VALUE (DOD)
TRUST ASSETS	
COMMUNITY PROPERTY	
Personal residence, $500,000 gross value	$ 500,000
Condo in Hawaii	150,000
80% interest in Commercial Real Property	8,000,000
Promissory note secured by deed of trust from installment sale	75,000
Unsecured promissory note from loan to Michael	15,000
Savings account at The Vintage Bank	25,000
Franklin Tax-Exempt Fund	33,500
225 shares of Georgia Pacific	17,500
275 shares of Merck	29,750
400 shares of Home Depot	20,500
2016 shares of Fleetwood	223,750
2045 shares of National R.V. Holdings, Inc.	85,000
1730 shares of IBM	90,000
877 shares of ITT	50,000
388 shares of Mobil Oil	90,000
U.S. Savings Bonds	50,000
Hank's classic 1929 Model A	20,000
Household furniture and personal effects	25,000
SEPARATE PROPERTY	
Vacation home at Lake Tahoe (Wendy's separate property); no mortgage	250,000
TOTAL ASSETS IN TRUST	**9,750,000**
ASSETS OUTSIDE TRUST	

JOINT TENANCY	
Checking account at The Vintage Bank	$ 15,000
Dodge Ram	35,000
21-ft Sea Ray ski boat	15,000
OTHER	
Insurance policy on Hank's life	25,000
Hank's qualified retirement plans	135,000
Wendy's IRA account with Wells Fargo Bank	50,000
TOTAL ASSETS OUTSIDE TRUST	**275,000**
TOTAL NET ASSETS	**$10,025,000**

Hank died on January 1, 2009, and we are administering his estate. The revocable family trust provides for its division into three trusts (survivor's trust, marital trust, and credit trust) at the first death, using a "true worth" date-of-distribution pecuniary marital/residuary credit formula gift. The trust also provides for dividing the marital trust into a pecuniary exempt marital trust and a residuary nonexempt marital trust. At the second death, the exempt marital trust and the credit trust will run to the children for their lives, and the nonexempt marital trust will be distributed to them outright. The trust provides that the residence and household effects are to be distributed to the survivor's trust. Wendy personally paid all Hank's funeral expenses, totaling $5000, and some administration expenses, totaling $5000.

Of the remaining administration expenses, $40,000 was paid from the trust before allocation, with $10,000 of administration expenses still outstanding on the allocation date. During administration, Wendy deposited her social security checks, totaling $2500, into the family trust. Wendy also used $25,000 of insurance proceeds to establish a mutual fund that was transferred to the family trust before allocation. She surrendered U.S. Savings Bonds and received $50,000, which she deposited into the trust savings account.

During administration, the stocks increased in value by $200,000, but all other assets remained at the same value as on the date of death. There was $2500 of income attributable to the stocks, which was deposited into the trust savings account. The subtrusts were distributed 14 months after Hank's death. The trust instrument does not waive interest on pecuniary gifts. Some administration expenses were deducted on IRS Form 1041 ($10,000) and some were deducted on IRS Form 706 ($50,000).

Hank's applicable exclusion amount (AEA) remaining at death is $3,260,000, calculated as follows:

AEA for the year of death	$3,500,000
Less lifetime gifts (decedent's ½ community property share of lifetime gift of commercial real property interest (= $250,000) less $10,000 annual exclusion for year of gift)	-240,000
Decedent's remaining AEA	$3,260,000

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.15A C. Form: Trust Summary: Two-Person Trust at First Death

§14.15A C. Form: Trust Summary: Two-Person Trust at First Death

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ESTATE OF _ _[*name*]_ _ **Date of Death:** _ _[*date*]_ _

TRUST SUMMARY: TWO-PERSON TRUST

Name of Trust: _ _[*e.g., The Rich Family Trust*]_ _

Date of Trust: _ _[*date*]_ _

Dates of Amendments, if any: _ _[*date*]_ _

Trustee(s) of Family Trust before death: _ _[*name(s)*]_ _

Successor Trustee(s): (1) _ _[*e.g., if cotrustees, list both names*]_ _**; (2)** _ _[*e.g., either* _ _[*name*]_ _ *or* _ _[*name*]_ _*as sole Trustee if the other cannot or will not act*]_ _**; (3)** _ _[*name*]_ _**; and (4)** _ _[*name*]_ _

SUBTRUSTS			
Name	Type	Trustee	Special Trustee
_ _[*e.g., _ _[name #1*]_ _]_ _ Survivor's Trust	R	Same as FT (Family Trust)	N/A
_ _[*e.g., _ _[name #2*]_ _]_ _ Credit Trust	IRR	Same as FT	_ _[*e.g., children as co-trustees*]_ _
_ _[e*.g., _ _[name #3*]_ _]_ _ Exempt Marital	IRR	Same as FT	N/A
_ _[*e.g., _ _[name #4*]_ _]_ _ Nonexempt Marital	IRR	Same as FT	N/A

Specific Gifts: _ _[*e.g., Residence to* _ _[*name, or e.g., survivor's trust*]_ _*; tangible personal property to* _ _[*e.g., wife*]_ _]_ _**.**

Type of Marital Deduction Formula:

Pecuniary Marital/Residuary Credit ___
Date-of-Distribution Value ___

Pecuniary Credit/Residuary Marital ___
Date-of-Death Value ___

Fractional Share

Hybrid

Survival Requirement for Division: _ _[*e.g. none*]_ _

GST Tax Exempt and Nonexempt Division Required?:

Type of GST Funding Formula:

Pecuniary Exempt/Residuary Nonexempt ___
Date-of-Distribution Value ___

Pecuniary Nonexempt/Residuary Exempt ___
Date-of-Death Value ___

Fractional Share ___

Powers of Appointment

Trust to Which Power Relates

	General/Limited	**Class of Appointees**
Credit, page___	**Limited**	**Children, spouses, grandchildren and descendants**
Marital, page___	**General (income only)**	**General**
Marital, page___	**Limited**	**Children, spouses, grandchildren and descendants**

Possible Disclaimer? Page ___

Tax Clause: Page ___

Report and Account Clause: Page ___

"Administrative Trust" Provisions: Page ___

Questionable Funding Issues: _____

COMMENTS
_ _[*add*]_ _

POUROVER WILL

Date of Will: _ _[*date*]_ _

Dates of Codicils: _ _[*date(s)*]_ _

Executor(s): _ _[*name(s)*]_ _

Any Specific Gifts: _ _[*e.g., distribution of tangible personal property to family trust*]_ _

Tax Clause: _ _[*e.g. none*]_ _

Guardian of Person:

(1) _ _[*name*]_ _

(2) _ _[*name*]_ _

(3) _ _[*name*]_ _

(4) _ _[*name*]_ _

COMMENTS

_ _[*add*]_ _

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.15B D. Form: Trust Administration Memorandum

§14.15B D. Form: Trust Administration Memorandum

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TRUST ADMINISTRATION MEMORANDUM

Provided to _____,

Co-trustees of The _____Family Trust

_ _[*Law firm name and address*]_ _

Date: _____

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MEMORANDUM REGARDING TRUST ADMINISTRATION

I. INTRODUCTION

Through our experience in helping people administer trusts, we have found that many people have unreasonable expectations about the way living trusts work following a death. There is sometimes a notion that a living trust magically avoids all administrative expenses and chores. This is one of the most common myths surrounding living trusts.

This misunderstanding is most common when, as in your situation, a married couple makes a joint living trust which provides for a division of the living trust into separate trusts following the death of one spouse. It often comes as a surprise to the surviving spouse that this division does not happen "automatically" and that the help of an attorney and CPA may be required, along with attendant legal and accounting fees.

The critical point to remember is that the estate tax savings opportunities this kind of estate plan creates would require a probate but for the existence of the living trust. Compared with probate, a living trust usually reduces the costs, delays, and work involved in administering a properly drafted estate plan, but it does not eliminate them entirely. One of the goals of this memo is to give you a better understanding of what procedures are required in carrying out this process that we call "trust administration."

II. THE FAMILY TRUST

A. Division of the Family Trust in Separate Trusts

In your particular case, the Rich Family Trust was a joint revocable trust as long as Hank T. Rich and you were both alive. However, now that Hank T. Rich has passed away, the living trust must be divided into separate trusts. Until division, the Rich Family Trust will continue to operate as a single "administrative trust." After division, the Rich Family Trust will cease to exist.

At division, a minimum of three separate trusts will be created: a "Credit Trust," "Marital Trust," and "Survivor's Trust." Additionally, the Marital Trust may have to be divided into two trusts for generation-skipping transfer tax purposes. There may also be additional separate trusts in the event you disclaim any assets. For sake of clarity, these will sometimes be referred to as the "Hank T. Rich Marital Trust", the "Hank T. Rich Credit Trust" and the "Wendy M. Rich Survivor's Trust." In addition, the words "under Declaration of Trust dated June 15, 1999" should always be used following the words the "Marital Trust", the "Credit Trust" or the "Survivor's Trust" for identification purposes.

The Survivor's Trust is a revocable, amendable trust which will include one-half of the community property and your separate property in the Rich Family Trust. The Marital Trust will consist of a dollar amount of Hank T. Rich's one-half interest in community property sufficient to eliminate any estate taxes (the amount over approximately $3.5 million less the amount of Hank's share of lifetime gifts other than annual exclusion gifts). This dollar amount is determined by a formula set forth in your Declaration of Trust. If Hank's taxable estate plus his share of lifetime gifts were less than $3.5 million (after deductions for debts and expenses of administration), this formula amount will be zero. However, based on the estimated values of your assets, Hank's taxable estate plus his share of lifetime gifts will be greater than $3.5 million. Thus, we know that the Marital Trust will have to be established. Until appraisals are completed and we know the date of death values of all assets in The Family Trust, we cannot be certain of this formula amount. The Marital Trust and Credit Trust and any subtrusts thereof, in contrast to the Survivor's Trust, are irrevocable trusts which will contain the balance of the property of The Family Trust not allocated to the Survivor's Trust.

While both Hank and you were alive, you served jointly as Co-Trustees of The Family Trust. Now that Hank has died, you will serve as sole trustee of the Family Trust. As successor trustee, your responsibilities will include the collection of assets and gathering of information necessary to make the division into separate trusts. Once that division is completed, you will also serve as successor trustee of the Marital Trust and Credit Trust (except that Bruce A. Myers will act as the special co-trustee for the determination of distributions of income of the Credit Trust) for as long as those trust exist or at least until you cease to serve as trustee and another trustee takes over.

B. Tax Consequences of Division

Under California community property law, Hank and you each owned an undivided one-half (½) interest in each and every asset that constituted your community property. Arguably, in dividing the Family Trust into separate trusts, you should allocate to each separate trust a one-half interest in each and every asset of the Family Trust that was community property. (If there is any separate property in the Family Trust, this would of course be treated differently.) Your separate property, of course, will be treated differently.

However, the terms of the Family Trust give you the authority to divide community property into separate trusts on a nonprorata basis. Nonprorata allocation means dividing the pool of assets in the Family Trust based on their total value rather than on an asset-by-asset basis. Although the IRS has not seriously challenged the tax consequences of nonprorata divisions in this context for many years, there was a rash of audits in the early 1990s in which the IRS took the position that this type of division was a taxable event, on the theory that a nonprorata division is really a sale between the deceased spouse's estate and the surviving spouse. Although these audits were eventually dropped, the IRS may try to assert this position again in the future. Moreover, even though the IRS dropped these audits, many experts in this field believe that the IRS has a legitimate argument.

Whether such a division is a taxable event is important. If it is, it will trigger capital gain for assets that have appreciated in value since the date of death as well as accelerate income for certain types of assets, such as promissory notes and accounts receivable, which are classified as "income in respect of a decedent" ("IRD") under the Internal Revenue Code. For capital gain purposes, the fact that community property receives a new step-up in basis at death will ameliorate these income tax consequences. For example, if real property is divided nonprorata soon after death occurs, there will be little or no appreciation subject to taxation. However, IRD items do not receive a new basis at death and, therefore, the acceleration of income could cause an immediate income tax burden.

However, although, as outlined above, there is some risk in making a nonprorata allocation of assets in most trust administrations. We make nonprorata allocations and do not report these transactions as a taxable event.

C. Pourover Wills

You will recall that, at the time you signed your living trust, you both also signed what we called "pour-over" wills. As we explained when we did your estate planning, the purpose of a pour-over will is to provide for distribution of assets that were omitted from the Trust, either intentionally or inadvertently. Whether or not a probate is required, the original of Hank's will must be deposited for safe-keeping with the County Clerk within 30 days of the date of death. On January 7, 2009, we filed Hank's will dated June 15, 1999, with the Napa County Superior Court.

One of your first steps should be to determine what assets, if any, were omitted from the Trust. Any such assets held in joint tenancy form or that pass to you by death beneficiary designation (such as life insurance or retirement plans), will not require a probate or any special proceedings. Nevertheless, for tax planning reasons, we recommend that you not collect any such assets without first discussing it with us. As we have discussed with you, it may be advisable tax-wise to make a disclaimer of your right of survivorship or beneficial interest in such assets.

If there are any assets outside the Family Trust which do not pass to you automatically and such assets exceed $100,000 in gross value ($200,000 of community property, since you own one-half of these assets), a probate will be required to transfer these assets to the Family Trust. If these assets do not exceed $100,000 in value, you can collect such assets as Trustee by a declaration procedure under Probate Code §13100. If it becomes necessary to commence a probate or collect assets through the declaration procedure, we will handle those aspects of administration for you. Currently, we do not know of assets exceeding $100,000 held outside the Trust, and, therefore, we do not anticipate a probate.

III. TRUSTEE DUTIES, POWERS, AND COMPENSATION

The rest of this memo is devoted to your administration of the Family Trust acting as an administrative trust, and the Marital and Credit Trust (and any subtrusts) and does not apply to the Survivor's Trust, unless otherwise specified. Please remember that, while you in essence own the assets of the Survivor's Trust, you do not "own" the assets of the Family Trust, the Marital Trust or Credit Trust in the normal sense. As far as the Marital Trust and Credit Trust are concerned, you have the right to use the assets for certain purposes for the rest of your life, but at your death these assets will pass to someone else. As trustee, you have a duty to these

future recipients to hold and protect the assets of these Trusts for their eventual benefit to the extent that you do not exhaust the Trust. Please keep these concepts in mind as you read the rest of this memo.

A. Standard of Trust Management

In managing the trust property, you must use at least ordinary business ability. However, if you have special skills, under California law you will be held to a higher standard of care. In any event, your management will be judged in light of the circumstances existing at the time transactions occur. If you exceed your trustee powers, you may be held liable for loss or damage to the trust estate.

B. Source of Trustee Powers

It is important that you understand the rules under which you must administer the Marital and Credit Trusts. These rules are derived from three sources: (1) the Declaration of Trust itself, (2) statutory law (in California, this is known as the "Trust Law," and is found in the Probate Code §§15000-19403), and (3) case law created by the courts.

The most important source of your trustee powers is the Trust itself. You should therefore read the Declaration of Trust carefully. Trust instruments generally contain two types of provisions: "dispositive provisions" that govern the distribution of property and "administrative provisions" that govern the powers of the trustee, payment of taxes and expenses, rules for interpreting the trust instrument, and other procedural issues. In reading the Trust, you will see that the bulk of the Trust is made up of these administrative provisions.

In creating a trust, the settlor may include any lawful provisions that he or she wishes to govern the trust relationship. Since tax considerations are often important considerations in creating a trust, the rights and duties of the trustee are often limited by the tax results desired. The provisions of a trust may override general provisions of the Trust Law, except when the law expresses a paramount public policy. Wherever the trust instrument does not provide for a given situation, the Trust Law applies.

C. General Duties of Trustee

Your basic duties as trustee involve the collection, management, and investment of trust assets and the accumulation and distribution of income and principal pursuant to the Trust. Another important set of duties relates to tax matters, which are explained in detail later on in this memo.

It is a fundamental principle of trust law that you must be faithful to the interests of the Trust and its beneficiaries. You occupy a position of trust and confidence and owe a duty of care to the beneficiaries. You have a duty to administer the Trust solely in the interest of the beneficiaries and to deal impartially with them.

You have a basic duty to keep the beneficiaries reasonably informed of the trust and its administration. At a minimum, we believe that this duty requires you to notify your children of the existence of the trust and their right to request information from you concerning your administration of the trust. We will send a letter to your children on your behalf explaining some basics of the operation of the trust.

You have a duty to take reasonable steps to take and keep control of trust property and to preserve the trust property and make it productive. You must not commingle trust property with your own property. You cannot use trust property for your own profit or for any nontrust purpose. You must not engage in any transaction that will result in a conflict of interest between you and the Trust or a beneficiary. (For example, you could not purchase an asset from the Marital Trust for less than fair market value.) You also have a duty to take reasonable steps to enforce claims of the Trust and to defend actions brought against the Trust.

You must carry out all trustee activities personally. In other words, you may not delegate your responsibilities to others. For example, you cannot give someone a power of attorney to handle your trustee duties. Only a duly authorized trustee has the power to transact business on behalf of the trust. However, you may hire attorneys, accountants, investment advisors, and others to consult with you concerning your administration of the Trust, and you may pay such advisors from the assets of the trust.

D. Principal and Income Act

The Uniform Principal and Income Act (Probate Code §§16320-16375) went into effect January 1, 2000, and significantly changed the way in which a trustee should think about principal and income.

In the past, "income" beneficiaries and "principal" beneficiaries were treated differently. The right to income has most often been thought to include the right to payment of dividends, rents, royalties, and similar items received as a current return on an investment. The notion of "current return on an investment" often coincides with that of "ordinary income" for income tax purposes. Capital appreciation was thought to accrue for the benefit of the principal beneficiaries, who most often were entitled to distributions following the termination of the income beneficiaries' interests. (Many trusts provide for invasion of principal for various purposes prior to the termination of the income beneficiaries' interests.) Those who are entitled to receive the trust assets at the termination of the trust are often referred to as "remainder beneficiaries," the ultimate class of principal beneficiaries.

As a result of these traditional notions of "principal" and "income," an inherent conflict was created that affected the way in which trust assets could be invested. Income beneficiaries would clamor for investments in income-producing assets (high-yield bonds, for example) while the principal beneficiaries demanded that the trustee take positions that produce capital appreciation. The trustee was required to do both or face the consternation of one class of beneficiaries.

In 1996 the Uniform Prudent Investor Act (Probate Code §§16045-16054) became law, and the trustee was instructed to make investment decisions "not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Probate Code §16047(b). The trustee was given a duty to diversify the investments of the trust. Probate Code §16048.

Since you will be acting as the trustees of ongoing trusts after the termination of the administration period, it will be necessary to track principal and income. Therefore, every time your CPA prepares the fiduciary tax return, he should also give you a breakdown of trust income and principal for trust accounting purposes.

E. Trust Investments

The Uniform Prudent Investor Act (the "Act") was added to the California Probate Code in 1996. Under the Act, a trustee, who invests and manages trust assets, must comply with the "prudent investor rule." The Act sets forth a framework which describes the prudent investor rule with regard to standard of care, portfolio strategy, risk, diversification, delegation, costs and compliance standards. The law is of considerable advantage to trustees because it provides common sense investment guidelines. Furthermore, it provides a favorable procedure for reviewing the trustee's actions that examines the investments made by the trustee in the context of the entire trust portfolio instead of viewing each asset in isolation. The basic reasons for establishing the Act were to:

(i) Emphasize portfolio investing rather than individual investments;

(ii) Recognize trade-offs in investing between risk and return;

(iii) Eliminate categoric restrictions on types of investments;

(iv) Require diversification investments; and

(v) Permit delegation of investment and management functions by trustee permitted.

The Act sets forth a laundry list of circumstances that are appropriate for a trustee to consider with regard to investments decisions: (1) general economic conditions; (2) inflation and deflation; (3) tax consequences; (4) the role each investment or course of action plays within the overall trust portfolio; (5) the expected return from income and the appreciation of capital; (6) information provided to the trustee from the beneficiaries; (7) needs for liquidity, regular income and preservation of capital; and (8) an asset's special relationship to the trust or to a beneficiary.

Under the Act, as trustee, you are now provided with statutory protection when treating one asset different than the norm if that particular asset has a special relationship to the trust or a beneficiary. More significantly, your course of action is now evaluated in the context of the "trust portfolio as a whole and as part of an

overall investment strategy having risk and return objectives reasonably suited to the trust." No longer are the trustee's individual asset investment decisions viewed in isolation. For example, if a trustee's investment of a specific asset were to generate a loss, this loss would be viewed in light of the entire trust portfolio. The trustee could have accepted the loss in order to offset other income of the trust or to allocate trust resources to less risky assets. The Act does not, however, shield you from liability in making unsound investments or failing to exercise your power of investment in the best interests to the trust.

Under the Act, a trustee is charged with the duty to diversify the investments when making and implementing the investment decisions. In addition, the Act sanctions the trustee's ability to delegate investment and management functions. However, the trustee is required to exercise prudence in the selection of an agent, to establish the terms/scope of the agent's duties and to periodically review the agent's overall performance and compliance with the terms of the delegation. This delegation does not permit you to avoid all responsibility. You must continue to take an active role in evaluating the agent. If you have any questions about the propriety of any investment, you should seek legal advice before making or continuing the investment.

F. Accounting and Record-Keeping

State law requires that you provide all beneficiaries with certain information upon request and account to such beneficiaries if they demand an accounting. In addition, you have the affirmative duty to give a full accounting of all trust transactions not less often than annually, or at the termination of the Trust, to all beneficiaries who are currently entitled to distributions of income or principal. Since you are the only person who fits that category for all trusts other than the Credit Trust, the trust instrument waives your requirement of accounting for the Credit Trust; you are not required to make formal accounting.

However, even though formal trust accountings are not required, it might prove wise to provide formal accounting for the future beneficiaries anyway. Internal accounting will be required as a matter of proper record-keeping and in order to prepare annual income tax returns for the trust. Since this information has to be recorded and assembled in any event, it takes relatively little additional effort to pass this information along to the future beneficiaries. Providing this information serves several purposes. First, it will give the beneficiaries a better understanding of the complexities of the trust administration process and the amount of work involved. Second, it will help avoid misunderstandings by showing that you are not trying to "hide" anything. Third, and most importantly from your point of view, it will start the running of a 3-year statute of limitations for all matters you disclose in the accounting. If no accounting is made, your liability exposure will continue indefinitely. On the other hand, for reasons of privacy, you may desire not to disclose this kind of information unless you absolutely have to. In a friendly family setting, this is probably appropriate. However, if the future beneficiaries are children from a prior marriage, we strongly recommend that formal accounting be provided.

Please note that a trust accounting is a legal document that should be prepared by a lawyer and must be presented in a certain format in order to qualify for the 3-year statute of limitations rule. It is different from a financial statement of the type prepared by an accountant. Although making formal accounting will add to the expense of administration, the cost is payable from the trust, is tax deductible, and will in essence be spread among all the beneficiaries.

Regardless whether you intend to make formal accounting, you must keep careful records of all trust transactions, including an accurate bookkeeping ledger with descriptive notations of all trust income and receipts, noting for each entry the date, the person to whom or from whom payment was made or received, the nature of the payment, and the amount. All disbursements for trust expenses should be made by check, *i.e.*, you should never pay cash for any trust expenses. You should set up a filing system to keep track of any trust documents and your financial records for the trust, including bank statements, statements of income received, bills for expenses, bank deposit receipts, canceled checks, copies of tax returns, and copies of correspondence relating to the Trust. These records should not be destroyed, but should be kept indefinitely.

If the Trust has a large number of assets or transactions, you may find it helpful to set up a more sophisticated bookkeeping system. Many people now own personal computers, either for personal use or in their businesses. If you own or have access to a personal computer, you might consider using a household or business accounting software package or general spreadsheet program to keep track of trust transactions. There are also commercial fiduciary services who assist individual trustees in keeping trust records and CPA firms sometimes offer these services. We would be happy to recommend someone to you or help you set up a

bookkeeping system that best fits your needs.

IV. TAX MATTERS

A. Taxpayer Identification Number

The taxpayer identification number we have obtained for the Family Trust is 96-5764312. Once the division has taken place, we will also obtain identification numbers for the Marital Trust and Credit Trust and any subtrust thereunder. You will only use these numbers on assets in the respective trusts. The Survivor's Trust, because it is a "grantor trust" under the Internal Revenue Code, will continue to use your social security number.

B. Estate Taxes

Since Hank's estate will exceed his available exemption equivalent, an estate tax return will have to be filed. However, because your estate was properly planned to take advantage of the unlimited marital deduction, no estate taxes will be due unless you elect to pay some tax now for strategic planning purposes. As successor trustee, it is your responsibility to file any required estate tax returns. We will generally prepare these estate tax returns for you, although your cooperation will be essential in providing us with all necessary asset and liability information in order to prepare accurate returns. The estate tax returns, if required, and any tax due, must be filed within nine (9) months following the date of Hank's death, or October 1, 2009, but for tax planning, we anticipate filing for an extension to file until April 1, 2010.

C. Appraisal of Real Estate

At our meeting on January 5, 2009, you requested that I take care of getting a formal appraisal of your real property. I expect the cost of the appraisal to be between $2,000 and $3,000. These appraisals will determine your new basis for such properties.

D. Income Taxes

For federal and state income tax purposes, all of the community property in the Family Trust (or outside the trust for that matter) will receive a new income tax basis equal to the fair market value at the date of Hank's death. A new depreciation schedule can be used for all such assets which are depreciable for income tax purposes. In addition, if you sell any such assets which have appreciated or depreciated in value since Hank's death and the date you purchased them, all gain or loss is forgiven, except for appreciation or depreciation occurring from the date of death forward. Thus, any assets placed in the Marital Trust or Credit Trust will have a basis equal to the date of death value of such assets, as will the assets in the Survivor's Trust. However, the assets in the Survivor's Trust and the Marital Trust, but not those in the Credit Trust, will also get another step-up in basis when you die.

You will have to file a joint income tax return with Hank for the year 2009. All income attributable to assets of the Family Trust prior to the date of Hank's death is reportable on that return. However, after that date, while the Family Trust is acting as an administrative trust, all income must be allocated between the administrative trust and you, individually, after the trust administration is completed. The Family Trust acting as an administrative trust may file the fiduciary return either on a calendar year of fiscal year end. The income allocated to the Survivor's Trust is reportable on your personal return, but the income from the other irrevocable trusts will be reported on fiduciary returns for each trust.

As Trustee of the Marital Trust and Credit Trust, you are required to file annual fiduciary income tax returns. The Marital Trust and Credit Trust must report on a calendar year basis and, unlike a probate estate, cannot elect a fiscal year. If the Trust distributes only trust income to you during the year, the Trust may file as a "simple trust." If, on the other hand, any trust principal is distributed to you during a given year in addition to trust income, the Trust must file as a "complex trust." The Trust may be a simple trust in some years and a complex trust in other years. "Trust income" and "trust principal" are determined under the terms of the trust and state law, as described below. Please note that penalties and interest may be imposed if you fail to file these fiduciary returns.

When trust distributions are made to you during a calendar year, or during the 65-day period following the end of a calendar year if you make a special election on the fiduciary return, such distributions will carry out

taxable income to you. In essence, the Marital Trust and Credit Trust get a deduction against taxable income for its distributions. You, as the beneficiary, will then pay the tax on this income rather than the Trust. Schedules K-1 will be issued showing the amount passing to you each year from the Marital Trust to report on your personal IRS Form 1040.

For trust accounting purposes, all trust receipts and disbursements need to be allocated between "income" and "principal" in accordance with the terms of the trust and the rules set forth in the Uniform Principal and Income Act (which can be found at Probate Code §§16320-16375). Please keep in mind that "trust accounting income" and "tax accounting income" are not the same. For example, capital gain is "income" for tax purposes. However, for trust accounting purposes, capital gain is allocated to principal and will not be distributed out to you as "net income" from the trust. The rules relating to allocation between principal and income are sometimes complicated. Your CPA or tax preparer must exercise care in making these allocations in order to properly track trust transactions.

V. ATTORNEYS' ROLE

As your attorneys, we will assist you in carrying out your trustee duties as described in this memo. We will also help you collect and value assets, pay debts and taxes, prepare the necessary transfer documents in connection with the division of the Family Trust into separate trusts, notify the beneficiaries of the existence of the Marital Trust, prepare any regular accounting, prepare any required death tax returns. We will also give you general advice as you request from time to time.

However, we generally do not prepare fiduciary income tax returns. We understand that you will be having Ima Kobayashi, CPA prepare the fiduciary income tax returns.

Please keep in mind that we represent you and do not represent any other beneficiaries of the trust. Any communication between you and our firm is subject to the attorney-client privilege and will be kept confidential. With your permission, we may provide information to the other beneficiaries and answer some of their questions. However, it would be unethical for us to give them legal advice. Furthermore, because you are a beneficiary as well as a trustee, we cannot render any legal advice to you in your capacity as a beneficiary if it would conflict with your duties as Trustee. Doing so might constitute a conflict of interest and a violation of our ethical requirements under the State Bar Rules.

VI. CONCLUSION

This memo is intended to serve as an overview of the trust administration process and your duties as Trustee. It is not intended to anticipate every possible problem that might arise during the course of administration of the Trust. If any questions arise that are not adequately explained in this memo or in the Trust itself, we urge you to contact our office first before taking any action.

__[*Signature*]__
_ _[*Typed name*]_ _

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.16 E. Checklist: Creating and Using Spreadsheet

§14.16 E. Checklist: Creating and Using Spreadsheet

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- **List date-of-death values for all assets whether held inside or outside the trust.** See Exhibit B in §14.86.
- **List any debt for each asset.** See Exhibit C in §14.87.
- **Use formula function to calculate net value.** See Exhibit D in §14.88.
- **List date of distribution (allocation).** See Exhibit E in §14.89.

Note: These dates vary among the assets. Most assets have the same allocation date, but for joint tenancy property or life insurance use the date of death; if an asset was distributed by a preliminary distribution, use that date; if an asset was sold or an account closed and transferred, use those respective dates.

- **List date-of-distribution value separately for trust and nontrust assets.** Total trust values at distribution date are needed in order to calculate targets. The sum of all targets will be equal to these totals. See discussion below; see Exhibit F in §14.90.
- **Use formula function to calculate net change for assets in trust and outside trust from date of death to date of allocation.** This step is very important because the result may (1) change the target for funding subtrusts, depending on the marital deduction formula used; (2) show whether there are capital gains (or losses if an IRC §645 election is made) on funding of a pecuniary formula with a particular asset; or (3) be used to cross-check entries to be sure the numbers balance. See Exhibit G in §14.91.
- **Determine the total value of all assets that pass outside trust.** List the values of all assets passing outside the trust, such as specific devises, joint tenancies, beneficiary designations, annuities, IRAs, life insurance, etc. See Exhibit H in §14.92.
- **Determine the shares and subtrusts to receive assets.** The columns that will be needed depend on the estate plan. The following are some typical examples.
- **Survivor's Trust/Disclaimer Trust Plan.** The trust provides that all assets go to the surviving spouse unless he or she disclaims assets. If there is no disclaimer, there will be no allocation among subtrusts. See Exhibit I in §14.93.
- **Survivor's Trust/Credit Trust (Without Marital Share).** The trust may provide for a marital share, but the total of assets subject to allocation is of such size that there is no marital share. Typically, this would be a trust in which, assuming only community property assets, the total trust estate is less than $7 million (assuming death occurs in 2009); or, if the deceased spouse's estate includes separate property, then the deceased spouse's separate property and his or her half of community property does not exceed $3.5 million (assuming death occurs in 2009). In this fact situation, create only survivor's and credit columns. See Exhibit J in §14.94.
- **Survivor's Trust/Credit Trust (With Marital Share).** The trust provides for a marital share and the total value of the trust estate is such that there will be a funded marital share, but it will be added to the survivor's trust rather than put into a separate marital trust. This would be a trust estate in which, assuming that all assets are community property, the total trust estate exceeds $7 million (assuming death occurs in 2009); or, if the deceased spouse has separate property, his or her separate property and his or her half of community property exceeds $3.5 million (assuming death occurs in 2009). In this case, create a survivor's share column, a marital share column (both of these will go into the survivor's trust), and a credit trust column. See Exhibit K in §14.95.
- **Survivor's Trust/Credit Trust/Marital Trust (Without GST Division).** This is the same as the example immediately above except that the marital share is placed in a separate marital trust. This applies if the decedent did not use any of his applicable exclusion amount with lifetime gifts. See Exhibit L in §14.96.
- **Survivor's Trust/Credit Trust/Marital Trust (With GST Division).** This is the same as the example immediately above except that the marital share is divided into two shares, one that is exempt from

generation-skipping transfer (GST) tax, and another that is not exempt from GST tax. This would be used where the decedent made gifts using part of his applicable exclusion amount to individuals or trusts other than GST skip persons. For example, if the decedent died in 2009, and he had gifted $500,000 to his children as of the date of his death, his credit trust would contain $3,000,000, he would have an exempt marital trust of $500,000 (for a combined GST tax exempt amount of $3,500,000) and a nonexempt marital trust of the excess over $500,000. In this situation, create a survivor's share (trust) column and a marital share divided between the survivor's nonexempt marital trust and the exempt marital trust. See Exhibit M in §14.97.

- **Survivor's Trust/Credit Trust (With GST Division)/Marital Trust**. This is a situation in which the decedent's credit trust exceeds the available GST exemption, so the credit trust is divided into two shares, one exempt from GST tax, the other not exempt. This will normally arise when the credit trust has over $3.5 million (assuming death occurs in year 2009), and no GST exemption has been used by the decedent. See Exhibit N in §14.98.

Note: As a practical matter, the most common circumstance expected by the author in which the credit trust is divided into exempt and nonexempt trusts for GST tax purposes is when there is a special-use valuation election under IRC §2032A.

- **Unusual situations.** Unusual situations arise, *e.g.,* when there is a disclaimer trust below the credit trust that will be funded; when the trustee only partially elected the QTIP for the marital trust; when part of the credit share is given to the children outright; or when there is some other distribution from the family trust to a third party at the first death. See Exhibit O in §14.99.
- **Comments.** Comments can be set forth in the last column to explain transfers during administration, such as a preliminary distribution or a distribution of a specific devise. See Exhibit P in §14.100.

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F. Establish Targets for Allocation Between Each Subtrust or Share

§14.17 1. Necessity of Targets

Once the spreadsheet with the various columns for funding is created and the assets are listed indicating whether they are or are not in the trust, the next step is to calculate the value of assets that will be allocated to the various subtrusts. These values are termed "targets." Once established, the targets are listed at the bottom of each trust column, with another entry for what is needed to complete the allocation. See bottom of Columns 10, 11, and 12 of Exhibit P in §14.100. On determining the targets, see §14.18.

The target for each trust is crucial. In a marital trust/credit trust situation, if the credit trust is overfunded (which means that the marital trust is underfunded), there will be an immediate estate tax when there otherwise would be none; additionally, on the death of the surviving spouse, a portion of the credit trust will be brought back into his or her taxable estate. See IRC §2036(a). If there is no marital trust, the credit trust may be overfunded unless expenses are deducted from it, again incurring a tax on the second death. See IRC §2036(a).

In *Estate of Gertrude Hoffman* (1982) 78 TC 1069, the surviving spouse received an allocation of less than half of the community property, principally because of an improper allocation of taxes and expenses. The deceased spouse left his share in trust, with the surviving spouse as income beneficiary. The court found that the surviving spouse had made a gift to the trust, which caused part of it to be included in her estate at death under IRC §2036. See also Rev Rul 84-105, 1984-2 Cum Bull 197.

It is axiomatic that the decedent's credit trust cannot be funded with more than his or her one-half of assets held in the (joint revocable) trust without creating a taxable event. Several private letter rulings, however, call this axiom into question (IRS Letter Rulings 200604028, 200403094, 200210051, 200101021): If the deceased spouse is given a general testamentary power to appoint all the trust property (both the deceased spouse's share and the surviving spouse's share) and, in default of exercise, the property is allocated to the credit trust and any excess to the surviving spouse outright, it is possible under these specific circumstances to fund part of the surviving spouse's assets into the deceased spouse's credit trust, without any adverse tax consequences. This technique may be useful in shifting property out of the surviving spouse's estate if the surviving spouse has substantial separate property and the deceased spouse's share is less than the applicable exclusion amount ($3.5 million in 2009). However, there is no basis step-up for the surviving spouse's assets included in the deceased spouse's estate because the property is treated as acquired by the decedent within 1 year of the decedent's death under IRC §1014(e). See IRS Letter Ruling 200101021.

Note that this technique only works if the spouses die in the correct order so that the deceased spouse has the power and the surviving spouse is the one with separate property. In *Kwang Lee*, TC Memo 2007-371, the husband died 46 days after his wife. Even though it was the intent of the husband's will that the wife be deemed to have predeceased the husband if she did not survive him by 6 months, the will did not give the wife a power of appointment and the court held that the terms of the will could not be used to change the order of death to qualify the purported gift of the husband's separate property for the marital deduction. In other words, a spouse must actually survive to be a "surviving spouse" for purposes of IRC §2056.

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§14.18 2. Seven-Step Process in Determining Targets

After ascertaining which assets are in the trust and which are not, and listing them on the spreadsheet, follow these seven steps to determine targets for the various subtrusts:

- Make adjustments between the surviving spouse and the trust estate. See §§14.19-14.26. Also note the possible adjustment under IRS Letter Rulings 200210051, 200101021, discussed in §14.17.
- Ascertain the value of the deceased spouse's and surviving spouse's shares of the trust estate. See §14.27.
- If there is a credit share and a marital share (normally distributed to either the survivor's trust or the marital trust), ascertain the value of each share. See §§14.28-14.44.
- If the credit trust will be divided into an exempt and a nonexempt credit trust, ascertain the value of each trust. See §§14.45-14.56.
- If the marital trust will be divided into exempt and nonexempt trusts for generation-skipping transfer tax purposes, ascertain the value of each trust. See §§14.45-14.56.
- Determine which trusts will receive the undistributed trust income. See §14.56A.
- Determine which trusts will receive the net principal change during administration. See §14.56B.

Once these factors have been reviewed, targets will be established for each subtrust. Allocation of assets between the subtrusts is based on the targets. The established targets are entered in the bottom left-hand corner of the spreadsheet. Further, entries are created showing what is needed to meet each of the targets so that the spreadsheet will continuously monitor how close the actual allocation is to the targets. Special target spreadsheets can also be used to establish the targets. See §§14.56C-14.56F.

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a. Step One: Make Adjustments Between Surviving Spouse and Administrative (Family) Trust

§14.19 (1) Trace Transactions

To make adjustments on the spreadsheet between the surviving spouse individually and the administrative trust estate, it is necessary to review and trace all transactions by the surviving spouse from the date of death to the date of allocation.

NOTE: The administrative trust is the family trust (*i.e.,* the original revocable trust consisting of the combined interests of the spouses) operating as the administrative trust until the allocation and funding of the subtrusts after the first death.

This review will result in adjustments between the deceased spouse's share and the surviving spouse's share. See §§14.20-14.26.

To establish a system for tracing the surviving spouse's transactions, do the following:

- At the start of the trust administration, obtain a new employer identification number (TIN) from the IRS for the administrative trust.
- Ask the surviving spouse to open a new bank account, using the administrative trust's TIN for the family trust operating as the administrative trust, and then advise the spouse to:
- Put all trust receipts into that account;
- Pay all trust expenses from that account;
- Use cash that was held in the name of the trust before the deceased spouse's death, *i.e.*, not funds from a joint tenancy bank account; and
- Not add any nontrust funds to this account (*e.g.,* life insurance proceeds payable directly to the surviving spouse, pay-on-death accounts, retirement benefit lump-sum distributions).
- If there was no cash in the trust, advise the surviving spouse to consider making a loan to the trust and to document the loan for later reimbursement.
- Also ask the surviving spouse to open a new personal account or to open a new checking account in his or her own name (or preferably in the survivor's trust's name) and to:
- Put all personal income, such as social security payments received after the deceased spouse's death, into this personal account; and
- Pay his or her personal expenses out of this account.

If the client follows these instructions, it will be easy to track all transactions from the date of death to the date of allocation. Many clients, however, are not careful about where they put receipts and from which account they pay expenses, so the practitioner usually must review all accounts used during the period of administration. Although the trust instrument normally does not require an accounting when there is a surviving spouse, a full informal accounting may be necessary to accomplish the adjustments described in §§14.20-14.26.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.20 (a) Expenses Improperly Paid From Family Trust

§14.20 (a) Expenses Improperly Paid From Family Trust

In reviewing the surviving spouse's transactions, look for personal expenses that should have been paid by the surviving spouse individually but that were improperly paid from the family trust. If such payments are found, adjust the target for the deceased spouse's share by increasing the total by half of the expenses and decreasing the target for the surviving spouse's share by half. As a practical matter, this can be accomplished by adding the expenses paid to the trust assets before dividing the trust in calculating the decedent's share of the trust estate, as illustrated in Step 1 of Exhibit U (§14.104A). This has the effect of increasing the decedent's share target by one-half of the amount added, and decreasing the survivor's share target by the same amount.

Examples:

- Medical expenses unpaid at death for the surviving spouse or dependents, and all postdeath medical expenses of the surviving spouse or dependents;
- Mortgage payments for any real property not held in trust;
- Business expenses for any business not held in the trust; *e.g.*, vineyard or winery operations, labor costs, utilities, etc.;
- Utility bills for personal residence, *e.g.*, electricity, gas, phone, water, garbage, cable television;
- Food and household expenses for the surviving spouse, dependents, or other beneficiaries;
- Miscellaneous personal expenses for the surviving spouse or other beneficiaries, including items such as:
- Clothing;
- Entertainment;
- Credit card debts incurred by the surviving spouse after the death of the deceased spouse;
- Child care expenses;
- Ongoing auto expenses such as oil, gasoline, repairs, DMV renewal, and auto insurance;
- Yard and pool maintenance for personal residence;
- Country club dues; and
- Newspaper and magazine subscriptions; and
- Premiums for life insurance on the surviving spouse's life, on a policy owned by the surviving spouse.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.21 (b) Trust Income or Receipts From Family Trust Assets Improperly Paid to Surviving Spouse

§14.21 (b) Trust Income or Receipts From Family Trust Assets Improperly Paid to Surviving Spouse

An adjustment must be made for income or receipts from assets in the family trust, which should have been deposited in the trust, but which the surviving spouse took personally. When determining the targets, the target for the deceased spouse's share is adjusted by increasing the target by half of the income or receipts and decreasing the surviving spouse's share by half of the income or receipts. As a practical matter, this can be accomplished by adding the income and receipts to trust assets before dividing the trust in calculating the decedent's share of the trust estate, as illustrated in Step 1 of Exhibit U (§14.104A). This has the effect of increasing the decedent's share target by one-half of the amount added and decreasing the survivor's share target by the same amount.

NOTE: The result in this adjustment is the same as in the adjustment in §14.20 because in both situations the surviving spouse has taken or has spent assets that belong in the trust. Because the surviving spouse is entitled to half of the trust assets, the adjustment in each of these is one-half against each share.

Examples:

- Dividends on stock held in the trust;
- Interest on accounts held in the trust;
- Interest from bonds held in the trust;
- Business income from business assets held in the trust;
- Royalty payments on assets held in the trust;
- Profit distributions from partnership interests held in the trust;
- Rental income from real property held in the trust;
- Interest and principal payments from notes held in the trust;
- Insurance proceeds from policies on which the trust was named as beneficiary; and
- Annuity proceeds from policies on which the trust was named as beneficiary.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.22 (c) Loans From Surviving Spouse to Family Trust

§14.22 (c) Loans From Surviving Spouse to Family Trust

Sometimes the surviving spouse will need to lend money to the family trust. In that situation, an adjustment must be made in the targets by decreasing the target for the deceased spouse's share by one-half of the amount of the loan and increasing the target for the surviving spouse's share by one-half the amount of the loan. As a practical matter, this can be accomplished by subtracting the loan amount from trust assets before dividing the trust in calculating the decedent's share of the trust estate, as illustrated in Step 1 of Exhibit U (§14.104A). This has the effect of decreasing the decedent's share target by one-half of the amount subtracted and increasing the survivor's share target by the same amount.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.23 (d) Surviving Spouse's Personal Income or Receipts Improperly Placed in Family Trust

§14.23 (d) Surviving Spouse's Personal Income or Receipts Improperly Placed in Family Trust

The surviving spouse frequently puts personal money received after death into the family trust. When calculating the targets, adjust the target for the deceased spouse's share by decreasing it by one-half of such income or receipts and by increasing the target for the surviving spouse's share by one-half. As a practical matter, this can be accomplished by subtracting the income and receipts from trust assets before dividing the trust in calculating the decedent's share of the trust, as illustrated in Step 1 of Exhibit U (§14.104A). This has the effect of reducing the decedent's share by one-half of the amount subtracted and increasing the survivor's share by the same amount.

NOTE: The result in this adjustment is the same as in the adjustment in §14.22 because the surviving spouse has, intentionally or not, lent money to the trust. Because the surviving spouse is entitled to half the assets, the adjustment in each of these situations is one-half against each share.

Examples:

- Social security payment to the surviving spouse;
- Dividends earned after death on stocks held outside the trust;
- Interest earned after death on accounts or bonds held outside the trust;
- Income or rents earned after death from business or real properties held outside the trust;
- IRA distributions not to the trust;
- Insurance proceeds received from a policy that did not name the trust as a beneficiary;
- Annuity proceeds that did not name the trust as beneficiary; and
- Retirement benefits received by the surviving spouse after the deceased spouse's death.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.24 (e) Expenses Paid Personally That Are Chargeable Entirely to Decedent's Share of Family Trust

§14.24 (e) Expenses Paid Personally That Are Chargeable Entirely to Decedent's Share of Family Trust

The surviving spouse may have personally paid expenses that should have been paid by, and are chargeable entirely to, the decedent's share of the family trust. See Prob C §11446. Perhaps the family trust lacked liquidity, or perhaps the surviving spouse simply paid these expenses from the wrong account. In this situation, adjust the targets by reducing the target for the deceased spouse's share and increasing the target for the surviving spouse's share by the total amount of these expenses. As a practical matter, this can be accomplished by subtracting the expenses paid from the decedent's share of the trust, as illustrated in Step 2 of Exhibit U (§14.104A). This has the effect of reducing the decedent's share target by the amount subtracted, and increasing the survivor's share target by the same amount.

Examples:

- Medical expenses for the deceased spouse that are unpaid at death;
- Administration expenses, including, *e.g.,* attorney fees, accountant fees, trustee fees, executor fees, notary fees, appraiser fees, trustee's travel expenses, storage, maintenance, tax consultants, bond premiums, selling expenses of assets held in trust, certified copies, filing fees for court procedures, and recording fees; and
- Funeral expenses, including, *e.g.,* funeral and burial ceremony, casket, burial plot for the deceased spouse or family, undertaker fees, food for mourners, clothing for burial, transportation of body to place of burial, tombstone, grave marker, monument, or mausoleum, and cost of landscaping the plot.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.25 (f) Expenses Paid Personally That Are Chargeable Equally to Decedent's Share of Family Trust and Survivor's Share

§14.25 (f) Expenses Paid Personally That Are Chargeable Equally to Decedent's Share of Family Trust and Survivor's Share

The surviving spouse may have personally paid expenses that should have been paid by, and are chargeable equally to, the decedent's share and the survivor's share of the family trust. Just as with regard to expenses described in §14.24, this may have occurred because of lack of liquidity in the family trust or because the surviving spouse paid the expenses from the wrong account. In this situation, however, the necessary adjustment requires decreasing the target for the deceased spouse's share by one-half of the expenses and increasing the target for the surviving spouse's share by one-half. As a practical matter, this can be accomplished by subtracting one-half the expenses paid from the decedent's share of the trust, as illustrated in Step 2 of Exhibit U (§14.104A). This has the effect of reducing the decedent's share target by the amount subtracted, and increasing the survivor's share target by the same amount.

NOTE: In both this situation and the one in §14.24, the target for the deceased spouse's share is reduced because the surviving spouse personally paid trust expenses, and the target for the surviving spouse's share is increased correspondingly; but the amount of adjustments is different. In the examples in §14.24, 100 percent of the expenses are chargeable to the deceased spouse's share, so the surviving spouse's share is increased by the same amount. In the situation described here, the expenses are chargeable as one-half to the deceased spouse's share and one-half to the surviving spouse's share, so each share is adjusted by only one-half of the expense. The reason for the difference is that in the examples here the obligations are community property obligations, while the obligations discussed in §14.24 are chargeable 100 percent to the deceased spouse. See Prob C §11446.

Examples:

- Mortgage payments on any real property held in the trust, *e.g.,* personal residence, rental property;
- Business expenses of any assets held in the trust, *e.g.,* vineyard or winery operations, labor costs, fertilizer, water, utilities, employment taxes;
- Insurance premiums on insurance policies on assets held in the trust, or life insurance owned by the trust;
- Repairs, maintenance, and improvements to assets held in the trust including, *e.g.,* capital repairs such as new roof, fencing, additions to personal residence, kitchen remodeling;
- Payments on credit card debts incurred by the deceased spouse, or by the deceased spouse and the surviving spouse;
- Property taxes on property held in the trust; and
- Any other expenses of the deceased spouse or community expenses left unpaid at death.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.25A (g) Form: Where to Put Receipts and From Where to Pay Expenses

§14.25A (g) Form: Where to Put Receipts and From Where to Pay Expenses

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WHERE TO PUT RECEIPTS
AND
FROM WHERE TO PAY EXPENSES

I. WHERE TO PUT RECEIPTS

A. *Assets in the Trust*. After the death of a Settlor, during the period of post-death administration, the Successor Trustee should deposit all cash receipts derived from assets held in the name of the Family Trust into a checking account opened in the name of the Successor Trustee of the Family Trust. If large amounts of cash are deposited (more than you would want to keep on hand in a checking account), you may transfer funds to other accounts in the name of the Family Trust (*e.g.*, savings account, money market, or short-term certificates of deposit).

***Examples*:**

- **Dividends on stock held in the trust.**
- **Interest on accounts in the trust.**
- **Bond interest from bonds held in the trust.**
- **Royalty payments on assets held in the trust.**
- **Business income from business assets held in the trust.**
- **Profit distributions from partnership interests held in the trust.**
- **Rental income from real property held in the trust.**
- **Interest and principal payments from notes held in the trust.**
- **Insurance proceeds from policies that named the trust as beneficiary.**
- **Annuity proceeds from contracts that named the trust as beneficiary.**

If there are dividend reinvestment accounts in the Family Trust, we strongly urge you to consider instructing the mutual fund or company to terminate the dividend reinvestment plan and make distributions of dividends in cash during the period of post-death administration of the Family Trust and during the ongoing administration of any irrevocable trusts. Dividend reinvestment accounts are extremely difficult to track for fiduciary accounting purposes.

B. *Assets Not in the Trust*. Receipts on assets not held in the trust should be deposited into the appropriate beneficiary's or surviving spouse's personal checking account (or, for a surviving spouse, into the Survivor's Trust checking account).

***Examples*:**

- **Social Security payments to the surviving spouse.**
- **Dividends on stock held outside the trust.**
- **Interest on accounts or bonds held outside the trust.**
- **Income or rents from business or real properties held outside the trust.**
- **IRA distributions not to the trust.**

- **Insurance proceeds from policies that did not name the trust as beneficiary.**
- **Annuity proceeds from contracts that did not name the trust as beneficiary.**

II. FROM WHERE TO PAY EXPENSES

Payable Out of Family Trust	Payable Personally (or From Survivor's Trust)
1. Medical expenses unpaid at death for decedent.	**1. Medical expenses unpaid at death for surviving spouse or dependents, and all post-death medical expenses of surviving spouse or dependents.**
2. Administration expenses: **__ attorney fees** **__ accountant fees** **__ trustee's fees** **__ executor's fees** **__ notarial fees** **__ appraiser fees** **__ travel expenses** **__ storage and maintenance** **__ tax consultants** **__ bond premiums** **__ selling expenses of assets held in trust** **__ certified copies** **__ filing fees for court proceedings** **__ recording fees**	**2. Mortgage payments on any real property not held in the trust.**
3. Funeral expenses: **__ funeral and burial ceremony** **__ casket** **__ burial plot for decedent or family** **__ undertaker's fees** **__ food for mourners** **__ clothing for burial** **__ costs for transportation of decedent's body to place of burial** **__ grave marker** **__ monument or mausoleum** **__ cost of landscaping plot**	**3. Business expenses for any business not held in the trust.**

4. Mortgage payments on any real property held in the trust (*e.g.*, personal residence or rental property).	**4. Utility bills for personal residence (*e.g.*, electricity, gas, phone, water, garbage, cable).**
5. Business expenses for any assets held in the trust (*e.g.*, vineyard or winery operations, labor costs, fertilizer, water, utilities, employment taxes).	**5. Food and household expenses for surviving spouse, dependents, or other beneficiaries.**
6. Insurance premiums on insurance polices on assets held in the trust, or life insurance owned by the trust.	**6. Miscellaneous personal expenses for surviving spouse or other beneficiaries:**
7. Repairs, maintenance, and improvements to assets held in the trust, including capital repairs such as new roof, fencing, additions to personal residence, remodel, etc.	**__ clothing** **__ entertainment** **__ credit card debts incurred by surviving spouse after death of decedent**
8. Payments on credit card debts incurred by decedent, or by decedent and surviving spouse.	**__ child care expenses** **__ ongoing automobile expenses such as oil, gasoline, repairs, DMV renewal, auto insurance**
9. Property taxes on property held in the trust.	**__ yard and pool maintenance for personal residence**
10. Miscellaneous (any other expenses of decedent or community expenses, unpaid at death).	**__ country club dues** **__ newspaper and magazine subscriptions**

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.26 (2) Calculate and Enter Net Adjustments on Spreadsheet

§14.26 (2) Calculate and Enter Net Adjustments on Spreadsheet

After entering all the adjustments on the spreadsheet, net each adjustment in each category and total all the adjustments, plus or minus for the deceased spouse's share and the surviving spouse's share. Finally, enter the total adjustment for each share, whether positive or negative. To accomplish the adjustments described above, the practitioner frequently will be doing what is in effect a full accounting of the activities of the surviving spouse for the period of administration. Even though the trust instrument normally does not require an accounting when there is a surviving spouse, a full accounting may be needed in order to accomplish the trust allocation.

NOTE: The phrase "the deceased spouse's share" includes the total amount of assets passing from the deceased spouse into the subtrusts, so adjustments are normally made at the share level, and not at the trust level.

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§14.27 b. Step Two: Make Adjustments Between Decedent Spouse's and Surviving Spouse's Shares of Trust Estate

The second step in calculating the targets of the various shares is making adjustments in values between the surviving spouse's and the deceased spouse's shares of the trust estate. The adjustments between these shares are determined as follows:

- Calculate what is community property and what is separate property to divide between the deceased spouse and the surviving spouse's shares. This step probably will already have been done as part of creating the spreadsheet. See §14.14.
- Frequently, the trust instrument provides for distribution of specific assets, such as tangible personal property or the personal residence, to the survivor's trust. These assets should be included in the surviving spouse's share.
- As set forth in §14.24, funeral expenses and the decedent's medical expenses unpaid at death are charged entirely to the deceased spouse's share of the trust estate because they are charged to the deceased spouse's separate property and the deceased spouse's one-half interest in community property. Prob C §11446. Most practitioners also charge administration expenses entirely to the decedent's share of the trust estate.
- Administration expenses paid by the trust are generally allocated entirely to the decedent's share. As a practical matter, this can be accomplished by subtracting one-half of the expenses from the decedent's share of the trust estate, as illustrated in Step 2 of Exhibit U (§14.104A). The decedent's share was already reduced by one-half of expenses paid when the depleted trust was divided. This adjustment has the effect of further reducing the decedent's share by one-half of the amount subtracted and increasing the survivor's share by the same amount.
- Allocate other unpaid debts one-half to the deceased spouse's share and one-half to the surviving spouse's share.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.28 c. Step Three: Make Adjustments Between Credit and Marital Shares

§14.28 c. Step Three: Make Adjustments Between Credit and Marital Shares

After making adjustments between the deceased spouse's and surviving spouse's shares of the trust estate, the surviving spouse's share has been allocated and the remaining adjustments involve only the deceased spouse's share of the trust estate. The first such adjustment with the deceased spouse's share is between the credit and marital shares. If there is a survivor's/marital/credit trust estate plan, the adjustment is between the credit and marital trusts. If there is a survivor's/credit trust estate plan, however, the adjustment is between the credit share (which is also the credit trust) and the marital share (which is distributed to the survivor's trust).

The trust instrument's marital deduction formula clause dictates the calculation of the optimum marital deduction amount (the amount necessary to reduce estate tax to zero at first death), as well as the tax consequences and mechanics of funding the subtrusts. If you do not understand the particular formula used in the trust instrument, you cannot calculate the amount that goes into the various subtrusts.

NOTE: The estate plan may not provide for zero estate tax at the first death.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.29 (1) Adjustments Based on Type of Marital Deduction Formula Used

§14.29 (1) Adjustments Based on Type of Marital Deduction Formula Used

Although there are hybrid formulas, the most commonly used formula is a pecuniary formula, either a pecuniary marital/residuary credit or a pecuniary credit/residuary marital formula. A pecuniary marital formula calculates the optimum marital deduction gift in terms of a dollar amount based on date-of-death (federal estate tax) values. The marital gift is the lead gift, with the credit share consisting of the residue of the deceased spouse's trust estate.

A pecuniary credit formula (also referred to as a "reverse pecuniary") calculates the maximum amount of the credit share in terms of a pecuniary amount based on date-of-death (federal estate tax) values, which results in no estate tax, with the marital deduction gift consisting of the residue of the deceased spouse's trust estate.

A second type of formula, a fractional share formula, expresses the credit share or the marital share as a percentage or fraction of the deceased spouse's estate rather than as a dollar amount, *e.g.*: "The marital trust shall consist of the smallest fractional share of the deceased spouse's interest in the trust estate that will eliminate federal estate tax by reason of the deceased spouse's death." There are no capital gain consequences of fractional share funding, and no need for reappraisal unless a nonprorata "pick and choose" fractional share formula is used. If a fractional share of every asset must be placed in separate trusts, however, future administration will be difficult.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/ (2) Adjustments Based on Funding Formula Used/§14.30 (a) Revenue Procedure 64-19

(2) Adjustments Based on Funding Formula Used

§14.30 (a) Revenue Procedure 64-19

When a pecuniary marital formula is used, the rules for funding formulas that will not jeopardize the marital deduction are found in Rev Proc 64-19, 1964-1 Cum Bull 682. Revenue Procedure 64-19 describes two kinds of allowable formulas for purposes of funding the assets allocated in kind to satisfy the pecuniary amount:

- Date-of-distribution funding ("true worth"), under which funding must be accomplished at the fair market value of the assets at the time of distribution (see §§14.31-14.32); and
- Fairly representative funding ("fairly representative"), in which assets must be fairly representative of the postdeath appreciation or depreciation of the trust estate (see §14.33).

There is also a third formula, often known as "minimum worth" funding (see §14.34), which is allowable because it meets the requirements of date-of-distribution funding described in Rev Proc 64-19.

Because true fractional share formula clauses give a fraction of each asset to the marital gift, these clauses are not affected by Rev Proc 64-19; however, it is unclear whether gifts labeled as "fractional shares" are pecuniary gifts when the instrument requires or allows selection of assets to satisfy the gift.

Revenue Procedure 64-19 does not apply when:

- A fractional share formula is used;
- A pecuniary amount may be satisfied solely in cash;
- The fiduciary has no discretion in selecting the assets that must be distributed in kind in satisfaction of a pecuniary amount;
- The assets selected for distribution in kind in satisfaction of a pecuniary amount are valued at their respective dates of distribution; or
- The fiduciary is required to satisfy a pecuniary gift with assets fairly representative of the postdeath appreciation or depreciation of all property available to satisfy the gift.

If the trust is silent on the manner of funding, funding is as of the date of distribution, not the date of death. Prob C §21118. The property selected for distribution by a fiduciary must fairly reflect net appreciation and depreciation between the valuation date and the date of distribution, if funding is at date of death value by the terms of the trust. Prob C §21118(a).

For a thorough discussion of funding formulas, see Drafting California Revocable Trusts, chap 11 (4th ed Cal CEB 2003).

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/ (b) True Worth Funding/§14.31 (i) Postdeath Appreciation

(b) True Worth Funding

§14.31 (i) Postdeath Appreciation

A "true worth" date-of-distribution pecuniary formula provides for funding at date-of-distribution values. In other words, the amount of the pecuniary gift is frozen at its date-of-death value but is funded with assets at their distribution or allocation date value.

EXAMPLE: Assuming death in 2009, if the deceased spouse's share of the trust estate has a date-of-death value of $3.6 million and the instrument uses a pecuniary marital formula, the marital share is $100,000. If the deceased spouse's trust estate is worth $3.7 million at the date of distribution, the marital share remains fixed at $100,000, and the credit share receives the residue, or $3.6 million.

Because the marital deduction gift is frozen at its date-of-death value in the above example, postdeath appreciation shifts to the credit share. In this manner, more than $3.5 million (for decedents dying in 2009), assuming full availability of the applicable credit amount, can pass to the credit trust without incurring estate tax at the first death. That the marital share receives no appreciation does not jeopardize the marital deduction. See IRS Letter Ruling 8746003.

True worth funding provides flexibility in the selection of assets to fund the various subtrusts. A nonprorata allocation of community property presents no problem, because the division is only of the deceased spouse's share of the community property.

The major disadvantage of true worth funding is that, when the marital share is funded with assets in kind (as opposed to cash) that have appreciated in value since the date of death, a taxable event occurs that triggers capital gain on the postdeath appreciation. This is based on the fact that the satisfaction of any pecuniary gift, whether or not a marital gift, with assets in kind using date-of-distribution values is a taxable event, causing realization of gain or loss (if an election is made to treat the trust as an estate for income tax purposes (see §13.44)) equal to the difference between the date-of-death value and the date-of-distribution value. If the trust is not treated as an estate for income tax purposes, no loss is recognized on funding because a trust (as opposed to an estate) may not recognize loss between related parties. Treas Reg §§1.661(a)-2(f)(1), 1.1014-4(a)(3); Rev Rul 56-270, 1956-1 Cum Bull 325; Rev Rul 60-87, 1960-1 Cum Bull 286; *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217.

If there is a pecuniary formula and the marital trust is funded with items of income in respect of a decedent (IRD) (see §§14.62-14.65) in kind, income is accelerated unless the items are specifically given to the marital trust.

Assets used to fund the marital share must be reappraised in order to calculate whether capital gain (or loss if an IRC §645 election has been made) results from funding. Other assets may also need to be reappraised in order to identify which assets have or have not gone up in value for purposes of selecting assets to fund the marital share.

NOTE: In case of estate tax repeal, true worth funding may not be the appropriate formula.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.32 (ii) Postdeath Depreciation

§14.32 (ii) Postdeath Depreciation

When a true worth date-of-distribution funding pecuniary formula is used, and the value of the deceased spouse's estate decreases in value between the date of death and the date of distribution, then the credit share is reduced accordingly.

EXAMPLE: Assuming death in 2009, if the deceased spouse's trust estate has a date-of-death value of $3.6 million and the instrument uses a pecuniary marital formula, the marital share is $100,000. If the deceased spouse's trust estate is worth $3.4 million at the date of distribution, the marital share remains fixed at $100,000, and the credit share receives the residue, or $3.3 million.

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§14.33 (c) "Fairly Representative" Funding

A "fairly representative" formula specifies that the assets used to fund the pecuniary gift are valued as of the date of death, but they must be prorated among the marital and credit shares so that the assets distributed to the credit trust and the marital trust, respectively, are fairly representative of postdeath appreciation and depreciation. See Rev Proc 64-19, 1964-1 Cum Bull 682, discussed in §14.30. There are no capital gains consequences on funding.

If assets appreciate during administration, assets fairly representative of that appreciation will have to be allocated to the marital share, thereby overfunding it and, by definition, underfunding the credit share. Conversely, if assets depreciate in value during trust administration, assets fairly representative of that depreciation must be allocated to the marital share, thereby underfunding the marital share and the credit share.

NOTE: The "fairly representative" pecuniary formula functions more like a fractional share formula than a pecuniary formula because the postdeath appreciation must be ratably shared between the pecuniary and residuary gifts.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.34 (d) Minimum Worth Funding

§14.34 (d) Minimum Worth Funding

The "minimum worth" formula combines aspects of the "true worth" and the "fairly representative" funding methods. For purposes of allocation to satisfy the pecuniary amount, assets are valued at the lesser of (1) their basis for federal income tax purposes or (2) their value on the date or dates of distribution. Because this formula provides that the maximum values used are date-of-distribution values, thus negating the possibility that the trustee can allocate appreciated assets to the credit share and depreciated assets to the marital share, it does not violate the rules in Rev Proc 64-19, 1964-1 Cum Bull 682. See §14.30.

This formula provides funding flexibility and generates no capital gain consequences on funding, because assets are distributed at the lower of their fair market value or basis. A disadvantage of this type of funding is that, because more assets are required to fund the marital share at the lower of fair market value or basis, the credit share may be underfunded as a result.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.35 (e) Calculate Which Subtrusts Receive Appreciation or Bear Depreciation

§14.35 (e) Calculate Which Subtrusts Receive Appreciation or Bear Depreciation

Which subtrust will receive appreciation or bear depreciation of trust assets for the period of administration depends on which formula is used to divide assets between the marital share and the credit share. The following summarizes which share receives appreciation or bears depreciation:

- **Pecuniary "true worth" date-of-distribution funding.** If a pecuniary marital/residuary credit formula is used, all appreciation or depreciation is attributed to the residuary credit share. If a pecuniary credit/residuary marital formula is used, all appreciation or depreciation is attributed to the residuary marital share.
- **Pecuniary "fairly representative" formulas.** Assets fairly representative of the appreciation or depreciation from the date of death to the date of distribution are allocated to both the credit share and the marital share; as a result, some of the depreciation and some of the appreciation will be allocated to both shares.
- **Pecuniary "minimum worth" funding.** Because a pecuniary marital/residuary credit formula funds the marital share at the *lower* of fair market value or basis, it will overfund the marital share even when there is appreciation, because more assets are needed to fund the marital share.
- **Fractional shares.** In a pure fractional share formula, like a pecuniary "fairly representative" formula, each share receives an equal share of the appreciation and bears an equal share of the depreciation for each asset.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.36 (3) Ascertain Where Various Deductions Were Taken

§14.36 (3) Ascertain Where Various Deductions Were Taken

Various deductions can be taken on:

- The fiduciary income tax return (IRS Form 1041);
- The decedent's and decedent's spouse's last personal income tax return (IRS Form 1040); or
- The federal estate tax return (IRS Form 706).

Where a deduction is taken affects the targets for the various subtrusts. It is also necessary to learn from what accounts the administration, last illness, and funeral expenses were paid. Frequently, these expenses are paid personally when they should have been paid by the family trust. See §14.24.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.37 (a) Administration Expenses

§14.37 (a) Administration Expenses

If the trust provides for payment of administration expenses not deducted under IRC §212 on IRS Form 1041 from the credit trust, the trustee has the option to deduct these expenses either (IRC §642(g)):

- On IRS Form 706 as IRC §2053 expenses of administration; or
- As IRC §212 deductions on the IRS Form 1041 fiduciary income tax return.

If the deceased spouse's estate exceeds the estate tax applicable exclusion amount, and if the trust instrument directs (or even permits) payment of administration expenses from the marital trust, the deduction must be taken on Form 706; otherwise, an estate tax may be imposed on the first death because no marital deduction is allowed for the portion of the marital trust used to pay administration expenses because it fails the "passing" requirement of IRC §2056. See *Estate of Lillian J. Lewis*, TC Memo 1995-168. There is a limited exception for "management" expenses attributable to property allocated to the marital trust. These expenses may be deducted on Form 1041 and paid from the marital trust without reducing the marital deduction. However, "transmission" expenses or management expenses attributable to property not included in the marital trust may not be paid from the marital trust. Treas Reg §20.2056(b)-4(d). A well-drafted marital deduction formula will prevent the payment of administration expenses from the marital trust that would result in imposition of estate taxes. To the extent that administration expenses are not deductible or are claimed on Form 1041, the formula will automatically increase the marital trust and reduce the credit trust as needed to reduce the estate tax to zero. Conversely, if the administration expenses are taken on Form 706, the formula will increase the credit trust by the amount of the claimed expenses. To avoid reducing the credit trust, these expenses should generally be deducted on Form 706. See §§14.38-14.40.

If the trust only provides for a credit and survivor's trust (no marital trust), the deduction should be taken on Form 1041 because the credit trust will have to pay expenses anyway.

NOTE: All administration expenses, but especially selling expenses, must be "necessarily incurred" in the proper settlement of the estate. Treas Reg §20.2053-3(a), (d). Tax courts in the Second, Fifth, and Sixth Circuits have held that this regulation is valid. *Estate of David Smith* (1972) 57 TC 650, aff'd (2d Cir 1975) 510 F2d 479; *Estate of Lee Chagra*, TC Memo 1990-352, aff'd without published opinion (5th Cir 1991) 935 F2d 1291; *Estate of Millikin v Commissioner* (6th Cir 1997) 125 F3d 339. The Seventh Circuit has held that, if administration expenses are allowable under state law, they are deductible under IRC §2053; the court also held that Treas Reg §20.2053-3 is invalid as to the necessity requirement. *Estate of Ballance* (7th Cir 1965) 347 F2d 419.

For a series of cases involving conflict between wills and trusts on allocation of estate taxes to the marital share, see *Patterson v U.S.* (8th Cir 1999) 181 F3d 927; *McKeon v U.S.* (9th Cir 1998) 151 F3d 1201; *Estate of Betty Pace Miller*, TC Memo 1998-416, aff'd (5th Cir 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.38 (i) Payment of Administration Expenses From Fiduciary Accounting Income

§14.38 (i) Payment of Administration Expenses From Fiduciary Accounting Income

Under Prob C §16340(c)(2), a trustee may pay administration expenses out of trust accounting income, so long as such payment does not cause the reduction or loss of the marital or charitable deduction. For this reason, it is essential that the trustee determine not only trust taxable income but trust accounting income during the period of administration. Under federal regulations, administration expenses are divided into "estate transmission expenses" and "estate management expenses." Treas Reg §20.2056(b)-4(d).

Estate transmission expenses are expenses that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and estate taxes, and distributing the decedent's property to those who are entitled to receive it. Estate transmission expenses include any administration expense that is not a management expense.

Estate management expenses are expenses incurred for investment, preservation, and maintenance of estate assets during a reasonable period of administration. Accounting, legal, and other professional fees may fall into both categories, depending on the nature of the services.

Estate management expenses for property passing to the marital share can be deducted from trust income without reducing the marital deduction. Under a marital deduction formula, transmission expenses that are claimed as estate tax deductions will in effect be charged against the marital share, but if claimed on IRS Form 1041, they must be charged against the credit share or the marital deduction will be reduced and an estate tax incurred. However, if there is a pecuniary marital gift and the marital share does not receive income under the state law (which in this case is California), then payment of either transmission or management expenses out of income will not reduce the marital deduction even if the deduction is claimed on Form 1041. Treas Reg §20.2056(b)-4(d)(5), Example 7. The payment of expenses from trust income also reduces the credit share because trust income ordinarily would be allocated to the credit share if there is a pecuniary marital gift. However, the regulation does provide some assurance that transmission expenses can be deducted on Form 1041 without triggering estate tax by reducing the marital deduction claimed on Form 706.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.39 (ii) Factors in Deciding Where to Deduct Administration Expenses

§14.39 (ii) Factors in Deciding Where to Deduct Administration Expenses

Consider the following factors in determining where to take the administration expense deductions:

- Relative fiduciary income and estate tax brackets;
- In the year of distribution of the trust, the relative income tax brackets of the trust beneficiaries and estate tax brackets;
- If there is a surviving spouse, whether the trust instrument requires or even permits payment of administration expenses from the marital trust (the marital deduction trust);
- If the instrument is silent on paying administration expenses, whether the marital deduction formula is a pecuniary credit/residuary marital formula;
- Whether payment of administration expenses from trust income would reduce or lose the marital deduction;
- The benefit of the current income tax deduction versus estate tax savings at the second death. Even if no estate tax is payable, the estate tax deduction in effect reduces the marital trust and increases the credit trust; and
- Whether there is a marital trust. See §14.37.

NOTE: In 2009, the applicable exclusion amount is $3.5 million. If the survivor's trust (including the marital share) will never exceed this sum, the deduction should be taken on IRS Form 1041 (no estate tax on second death; marital deduction tax-free amount increased on first death). See IRC §2010(c).

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.40 (iii) General Rules for Deducting Administration Expenses

§14.40 (iii) General Rules for Deducting Administration Expenses

The following rules are suggested guidelines for deciding where to take administration expense deductions.

- **Rule 1.** If estate tax is due, take the deduction on the estate tax return.
- **Exception.** If the estate tax bracket is lower than the effective combined rate of federal and state fiduciary income tax, consider taking the deduction on the income tax return.
- **Rule 2.** If no estate tax is due, take the deduction on the fiduciary income tax return.
- **Exception 1.** Consider taking the deduction on the estate tax return instead if all of the following are true: (1) the deceased spouse was married at the time of death; (2) the deceased spouse's estate exceeds the available exclusion amount; (3) the will or trust creates a marital deduction based on a formula tied to the adjusted gross estate; and (4) it is expected that the surviving spouse's estate will be subject to estate tax at his or her death.
- **Exception 2.** If the estate exceeds the available exclusion amount and the trust instrument directs or even permits payment of administration expenses from the marital trust (the marital deduction trust), take the deduction on the estate tax return. See §14.37.
- **Exception 3.** If the estate exceeds the available exclusion amount, and the trust instrument is silent on what source is to be used to pay administration expenses, and a pecuniary credit trust/residuary marital trust formula is used, take the deduction on the estate tax return. (A number of practitioners believe, however, that some administration expenses may be deducted on the income tax return even if a pecuniary credit trust/residuary marital trust formula is used and the trust instrument does not require administration expenses to be paid from the credit trust. See the possible exception below.)
- **Possible Exception 4.** If the estate exceeds the available exclusion amount, take the portion of administrative expenses allocated to income under the trust instrument or California law on the income tax return, but only to the extent that the marital deduction regulations (see Prob C §16340(c)(2)) provide that such expenses may be paid from trust income without reducing the marital deduction. See §14.38.

NOTE: The election to use the deduction may be made item by item, or a particular item may be divided and used partly on the estate tax return and partly on the fiduciary income tax return.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.41 (b) Expenses of Last Illness

§14.41 (b) Expenses of Last Illness

Medical expenses unpaid at death, but paid within 1 year after death, are deductible for tax purposes as an estate tax deduction on the federal estate tax return or as an income tax deduction on the deceased spouse's income tax return. IRC §213(c).

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.42 (i) Factors in Deciding Where to Deduct Expenses of Last Illness

§14.42 (i) Factors in Deciding Where to Deduct Expenses of Last Illness

The following are factors to consider in deciding where to deduct last-illness expenses:

- The date of payment of medical expenses;
- The 7.5-percent floor on income tax deductions under IRC §213(a);
- Relative personal income and estate tax brackets;
- The fact that taking the deduction on the income tax return in effect reduces the estate tax deduction for unpaid income taxes; and
- The benefit of the current income tax deduction versus estate tax savings at the second death. Even if no estate tax is payable, an estate tax deduction in effect reduces the marital trust and increases the credit trust.

NOTE: In 2009 the applicable exclusion amount is $3.5 million. If the survivor's trust (including the marital share) will never exceed this sum, the deduction should be taken on IRS Form 1041 (no estate tax on second death; marital deduction tax-free amount increased on first death). See IRC §2010(c).

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.43 (ii) Application of General Deduction Rules to Expenses of Last Illness

§14.43 (ii) Application of General Deduction Rules to Expenses of Last Illness

The following general rules for determining where to deduct administrative expenses can be applied when considering where to take the deduction for last illness expenses.

- **Rule 1.** If estate tax is due, take the deduction on the estate tax return.
- **Rule 2.** If no estate tax is due, take the deduction on the income tax return.
- **Exception.** If all the following factors are true, consider taking the deduction on the estate tax return instead: (1) the deceased spouse was married at the time of death; (2) the deceased spouse's estate exceeds the available exclusion amount (*e.g.,* $3.5 million in 2009); (3) the will or trust creates a marital deduction based on a formula tied to the adjusted gross estate; and (4) it is expected that the surviving spouse's estate will be subject to estate tax at his or her death.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.44 (4) Determine Interest Payments, Based on Marital Deduction Pecuniary Formula

§14.44 (4) Determine Interest Payments, Based on Marital Deduction Pecuniary Formula

For determining the targets for allocating the assets between the credit share and the marital share, the respective shares' targets may have to be adjusted for the payment of interest on the pecuniary share. A pecuniary gift, including one in trust, bears interest if it is not distributed within 1 year after the decedent's death. See Prob C §16340(b). Accordingly, if a pecuniary formula is used to divide assets between the credit share and the marital share, the pecuniary amount bears interest unless the trust instrument waives it. Prob C §12003. The rate of interest is three percentage points less than the legal rate on judgments in effect 1 year after the date of the testator's death. Prob C §12001. The interest rate is currently 7 percent because the legal rate on judgments is 10 percent. CCP §685.010. The interest on the pecuniary amount is computed as simple interest because there is no compounding of interest on judgments. *Westbrook v Fairchild* (1992) 7 CA4th 889, 9 CR3d 277. Therefore, the residuary share should be reduced by the amount of the interest, which is paid to the pecuniary share, and the respective targets should be adjusted.

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§14.45 d. Steps Four and Five: Make Adjustments Between Exempt Credit Trust and Nonexempt Credit Trust and Between Exempt Marital Trust and Nonexempt Marital Trust

The step four and five adjustments concern generation-skipping transfer (GST) tax allocation issues. If the credit trust exceeds the deceased spouse's remaining IRC §2631 GST exemption, then an adjustment must be made between the exempt credit trust and the nonexempt credit trust for GST tax purposes. This will occur if the executor makes the IRC §2032A special use valuation election, because the election does not apply for GST tax purposes with the consequence that the "packed" credit trust will exceed the amount that can be shielded by the GST exemption. More commonly, for purposes of the GST tax, an adjustment is necessary between exempt and nonexempt marital trusts. The discussion in §§14.46-14.56 focuses on the adjustment between these two trusts.

A detailed discussion of the GST tax is beyond the scope of this chapter. For complete discussion, see Drafting California Revocable Trusts, chap 2 (4th ed Cal CEB 2003); California Will Drafting, chap 15 (3d ed Cal CEB 1992).

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§14.46 (1) Identify GST Tax Formula

Just as different formulas are used for allocating assets between the credit trust and the marital trust (or shares), different formulas are used for allocating assets between an exempt marital trust and a nonexempt marital trust. If a pecuniary formula is used, satisfaction of the pecuniary amount in kind must be at date-of-distribution values or must be made on a basis that fairly reflects net appreciation and depreciation, from the date of death, of all assets available for funding. Treas Reg §26.2642-2(b)(2)(i). The funding of assets into a pecuniary GST trust at date of distribution values is a taxable event. See §14.31. This requirement is the same as that specified in the marital deduction formula under Rev Proc 64-19, 1964-1 Cum Bull 682. See §14.30.

A "pick and choose" fractional share formula is permitted if the funding is based on either the fair market value of the assets on the date of funding or is determined in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the date of death to the date of funding. Treas Reg §26.2654-1(b)(1)(ii)(C).

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.47 (2) When to Consider Allocation

§14.47 (2) When to Consider Allocation

As a general rule, allocation of the deceased spouse's GST exemption must be considered whenever:

- The deceased spouse's gross estate exceeds the applicable exclusion amount; or
- Distribution of the deceased spouse's estate is to a trust or is outright to anyone other than the surviving spouse or children (or children of predeceased children or certain collateral heirs under IRC §2651(e)). An example of a potential generation-skipping trust is one that will continue for the surviving spouse for life with remainder to children, in trust until 35, but if the children die before 35, to their issue by right of representation.

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§14.48 (3) Automatic Allocation Rules

To the extent it is not allocated by the executor on Schedule R of a timely filed IRS Form 706, the GST exemption is automatically allocated to direct skips after the deceased spouse's death; if there is an excess, the balance is allocated pro rata to trusts in which a taxable termination may occur or from which a taxable distribution may be made. Treas Reg §26.2632-1(d)(2). Automatic allocations are irrevocable, and an allocation by the executor after the automatic allocation takes effect will be ineffective. But see IRS Letter Ruling 200223016, which allowed an extension of time to make a late allocation of GST exemption to avoid the automatic allocation of GST exemption after the taxpayer failed to make the allocation on a timely filed Form 706. No automatic allocation of GST exemption is made, however, to "a trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust"—*i.e.,* a marital trust for which a qualified terminable interest property (QTIP) election is made. Treas Reg §26.2632-1(d)(2).

Thus, if there are no direct skips at death and no QTIP trust (because the deceased spouse's estate is less than the available applicable exclusion amount or because the marital share is distributed to the survivor's trust), the deceased spouse's GST exemption is automatically allocated to the credit trust. Therefore, in a typical simple A/B trust division, when the deceased spouse's estate is less than the available applicable exclusion amount and is being allocated entirely to the credit trust, it is not necessary to complete and attach Schedule R to Form 706. In 2004 and following, because the applicable exclusion amount and the GST exemption are the same, the credit trust will need to be divided into exempt and nonexempt trusts only when the credit trust exceeds the applicable exclusion amount, which would only be when an IRC §2032A special-use valuation is made.

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§14.49 (4) Reverse QTIP Election

In a typical survivor's/marital/credit division, the automatic allocation rules allocate exemption only to the credit trust. No automatic allocation is made to a "trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust" (Treas Reg §26.2632-1(d)(2)). Thus, if the deceased spouse's estate exceeds the applicable exclusion amount, and if the marital share is passing to the marital trust as opposed to the survivor's trust, the automatic allocation rules do not apply because distributions to anyone other than the surviving spouse from the marital trust will be treated as gifts by the spouse and any assets remaining in the marital trust on the survivor's death will be included in the survivor's estate under IRC §2040. The result is that, unless any unused exemption amount of the deceased spouse is allocated to the marital trust, for which the surviving spouse is considered a new transferor, the unused exemption amount of the deceased spouse will be wasted.

To fully allocate the GST exemption, a "reverse QTIP election" often must be made under IRC §2652(a)(3). This provision, which applies only to QTIP trusts and not to other forms of marital trusts, such as "estate trusts," essentially allows the executor to make an election to treat the deceased spouse as the transferor of the marital trust on the surviving spouse's death for GST tax purposes, even though the surviving spouse is the transferor of the marital trust for estate tax purposes under IRC §2044. This election must be made, if at all, by listing the exempt QTIP trust on Schedule R of IRS Form 706 and allocating a portion of the GST exemption to the trust. As with the QTIP election, the reverse QTIP election may be made on a late filed 706 return as long as it is the first return filed. Treas Reg §§20.2056(b)-7(b)(4), 26.2652-2(b). See §12.56. If the executor makes a protective QTIP election, a protective reverse QTIP election must be made at the same time. Treas Reg §26.2652-2(b).

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.50 (a) Example of Reverse QTIP Election

§14.50 (a) Example of Reverse QTIP Election

Because the GST exemption and the applicable exclusion amount are the same (and assuming there is no use of the applicable exclusion amount before death), then the dollar amount in the credit trust and the amount of the GST exemption will be the same, and there will be no need for a reverse QTIP election for property allocated to the marital trust. However, if the decedent has made a gift to a non-skip person trust or individual, the decedent will have used up part of his applicable exclusion amount but none of his GST exemption, and therefore there will be a reverse QTIP election for a portion of the marital trust. For example, if there is a death in 2009 and the decedent had given $500,000 to his son, the amount going into the credit trust for GST tax purposes would be $3 million, the amount equal to the decedent's remaining applicable exclusion amount, and the remaining $500,000 of GST exemption would be wasted; however, if the executor makes the reverse QTIP election with respect to a marital trust (which qualifies as a QTIP trust) funded with $500,000 and allocates the remaining GST exemption to the marital trust on Schedule R, the deceased spouse will be deemed the transferor of the marital trust for GST purposes on the death of the surviving spouse, and the entire $3.5 million of GST exemption will have been allocated. The actual amount passing to the credit trust depends on the amount of trust income and appreciation during the administration period, which will be allocated to the credit share or the marital share depending on the marital deduction formula. However, GST exemption is applied based on date-of-death values. Therefore, $3 million of GST exemption will be applied to the credit trust in the above example regardless of whether income and appreciation are allocated to the credit share or the marital share, provided that assets with a date-of-death value of $3 million are allocated to the credit trust.

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§14.51 (b) Extension to Make Reverse QTIP Election

In IRS Letter Ruling 9411010, the trust provided for creation of two QTIP trusts; however, IRS Form 706 as filed showed no evidence of an intent to make the reverse QTIP election. Later, the election was made on an amended Schedule R, and was permitted by the IRS. The IRS also ruled, however, that extending the time for making the reverse QTIP election did not extend the time for allocating GST exemption, with the result that the automatic allocation rules applied. Thus, because the regulations prohibit automatic allocation of GST exemption to a QTIP trust unless a reverse QTIP election is made, making the reverse QTIP election on an amended return might not exempt the QTIP trust from GST tax. In other words, two things have to happen to exempt the trust: A reverse QTIP election must be made *and* the exemption must be allocated to the QTIP trust. See, *e.g.,* IRS Letter Ruling 199948024 (allocation of GST exemption to inter vivos QTIP trust void because no reverse QTIP election was made). However, any remaining unused GST exemption that was not already allocated under the automatic allocation rules may be allocated to the QTIP trust when the reverse QTIP election is made on an amended return. Treas Reg §26.2632-1(d)(2); IRS Letter Ruling 200047013.

NOTE: In Rev Proc 2004-47, 2004-2 Cum Bull 169, the IRS provides a simplified method for obtaining an extension of time to make the reverse QTIP election that requires neither a request for a private letter ruling nor the user fee required when making such a request. The procedure is available only if the election was not made on the return because the estate relied on the advice of a qualified tax professional and the estate has sufficient unused GST exemption to fully exempt the reverse QTIP trust under the automatic allocation rules.

In IRS Letter Ruling 9519016, the IRS again granted an extension to make the reverse QTIP election when an amended Schedule R was filed. The trust had provided for dividing a QTIP trust into two trusts, one of which was to be funded with an amount equal to the decedent's unused GST exemption. The original Schedule R did not properly make the reverse QTIP election and allocated the GST exemption to the undivided QTIP as a whole. The IRS allowed the extension of time for making the reverse QTIP election and allowed the exemption to be applied to that portion of the QTIP trust having the same value as the unused exemption amount. See also IRS Letter Ruling 200018036 (reverse QTIP election timely when made on first estate tax return filed, even though tax return was late; remaining GST exemption automatically applied to QTIP trust). In IRS Letter Ruling 200427006, the IRS granted an extension to sever a QTIP trust into exempt and nonexempt trusts and to make a reverse QTIP election for the exempt QTIP trust on an amended late return. The amended return allocated the remaining GST exemption, which was incorrectly allocated on the original return, to the exempt QTIP trust.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.52 (c) Partial Reverse Election Not Permitted

§14.52 (c) Partial Reverse Election Not Permitted

Partial reverse elections under IRC §2652(a)(3) are not permitted. A reverse election must be made with respect to all property in the trust. Treas Reg §26.2652-2(a). Thus, if the QTIP trust exceeds the amount of available GST exemption, the trust must be divided into two separate QTIP trusts or shares.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.53 (d) Dividing QTIP Trust for Reverse Election or Credit Trust in Order to Have Exempt and Nonexempt Credit Trusts

§14.53 (d) Dividing QTIP Trust for Reverse Election or Credit Trust in Order to Have Exempt and Nonexempt Credit Trusts

A single trust treated as a separate trust may be divided at any time into separate trusts. Treas Reg §26.2654-1(a)(3). For these purposes, substantially separate and independent shares for different beneficiaries are treated as separate trusts. Treas Reg §26.2654-1(a)(1)(i).

The general rule, however, is that the severance of a single trust into separate trusts is not recognized for GST tax purposes unless certain specified conditions are met. The trust may be severed for GST tax purposes if the severance is effective under local law and either of the following two conditions is true (Treas Reg §§26.2642-6(d); 26.2654-1(b)(1)):

- The trust instrument provides that the trust is to be divided on the transferor's death; or
- The trustee has discretionary authority to sever the trust; *and*
- The terms of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as provided in the original trust;
- The trusts are severed before the estate tax return is filed; and *either*
- (i) The new trusts are severed on a fractional basis; or
- (ii) If the governing instrument requires severance on the basis of a pecuniary amount, the pecuniary payment meets the requirements of Treas Reg §26.2654-1(a)(1)(ii).

Under Treas Reg §26.2654-1(a)(1)(ii), the pecuniary amount is a separate and independent share if:

- The trustee is required to pay appropriate interest to the beneficiary; and
- If the pecuniary amount is payable in kind on the basis of values other than the date-of-distribution value of the assets, the trustee is required to allocate assets to the pecuniary payment in a manner that reflects net appreciation or depreciation (from valuation date to the date of payment) in the value of the assets in the fund available to pay the pecuniary amount.

When the estate tax return is filed, if a court order severing the trust has not been issued, the executor must attach to the return a statement that a proceeding has been started to sever the trust, describing how the trust will be severed, and attach a copy of the petition. If the governing instrument of the trust or local rule authorizes severance, the executor must indicate on the estate tax return that separate trusts will be created, and set forth how the trust will be severed and the separate trusts funded. Treas Reg §26.2654-1(b)(2). Either a severance of the trust or the commencement of a proceeding to sever the trust must occur before the due date of the return, including extensions. Treas Reg §26.2654-1(b)(1)(ii)(B).

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§14.54 (e) Court Petition to Divide QTIP Trust or Credit Trust

If it is necessary to divide the marital trust to make a reverse QTIP election, or if the credit trust needs to be divided into exempt and nonexempt credit trusts and the trust document does not grant the trustee authority to divide the QTIP trust, a court petition may be filed. See Prob C §17200 (proceedings concerning internal affairs of trust). On petition by a trustee or a beneficiary, the court may, for good cause shown, divide a trust into two or more separate trusts if the court determines that a division will not defeat or impair the trust's purposes or the interests of the beneficiaries. Prob C §15412. In IRS Letter Ruling 200543037, the IRS agreed to honor a state court order that split a QTIP trust into exempt and nonexempt trusts and provided that estate tax payable on the death of the surviving spouse was to be paid from the nonexempt trust to the extent possible, noting that the decree was binding on the trust beneficiaries before the survivor's death.

PRACTICE TIP: Until the petition is filed, do not divide the trust into GST tax exempt and nonexempt subtrusts or make an allocation of assets accordingly, because a mixed inclusion ratio will result. It is unnecessary to postpone division of the trust until a court order issues, however, as long as a copy of the filed petition is attached to IRS Form 706.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.55 (5) Allocate Appreciation and Depreciation

§14.55 (5) Allocate Appreciation and Depreciation

Which subtrust receives appreciation and which receives depreciation for the period of administration depends on which formula is used to divide the GST exemption between the exempt and nonexempt credit and marital trusts. The following summarizes which trust receives appreciation or bears the depreciation.

- **Pecuniary formula date-of-distribution funding.**
- Pecuniary nonexempt/residuary exempt: All appreciation or depreciation is allocated to the residuary exempt trust.
- Pecuniary exempt/residuary nonexempt: All appreciation or depreciation is allocated to the residuary nonexempt trust.
- **Pecuniary formula "fairly representative" funding.** Assets fairly representative of the appreciation and fairly representative of the depreciation are allocated to both the nonexempt trust and the exempt trust. The result is that some of the depreciation and some of the appreciation is allocated to both trusts.
- **Fractional share funding.** Each trust receives a proportionate share of the appreciation or depreciation for each asset.

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§14.56 (6) Determine Whether Interest Must Be Paid on GST Exempt or Nonexempt Pecuniary Share

The targets established for the exempt marital trust and the nonexempt marital trust (or exempt and nonexempt credit trust, if applicable), will need to be adjusted if interest must be paid on the pecuniary share. The trust instrument should be reviewed to learn whether interest will be required after 1 year from the date of death up to 15 months after death, or whether it has been expressly waived. See Treas Reg §26.2642-2(b)(4)(ii); Prob C §16340(b). See also §14.44. After 15 months, however, if interest is waived, one of the following must happen (Treas Reg §26.2642-2(b)(4)(ii)):

- The trust must require the trustee to allocate to the pecuniary payment a prorata share of the income earned between the date of death and the date of payment (even if interest is otherwise waived); or
- The property must be irrevocably set aside to satisfy the pecuniary payment within 15 months after the transferor's death.

Assuming interest is not waived and the decedent's unused GST exemption exceeds the decedent's remaining applicable exclusion amount, *i.e.,* when the decedent made lifetime taxable gifts to non-skip persons (see §14.50), interest on the pecuniary share is allocated to the exempt marital trust because the payment of interest from the credit trust reduces the amount of GST exemption that must be allocated to the credit trust to completely exempt the trust.

EXAMPLE: In the married couple hypothetical in §14.15, the deceased spouse made lifetime transfers of $240,000 to nonskip persons. Thus, the decedent's remaining applicable exclusion amount is $3,260,000, while the decedent's unused GST exemption is $3,500,000. The remaining unused GST exemption of $240,000 may be applied to the exempt marital trust. In the hypothetical, $13,737 of interest is paid on the pecuniary marital share because funding occurs 2 months later than 1 year after the date of death. The payment of interest reduces the credit trust by $13,737, with the consequence that this additional amount of GST exemption also may be applied to the exempt marital trust. Therefore, the exempt marital trust target is $253,737.

On the other hand, assuming interest is not waived and the decedent's remaining applicable exclusion amount exceeds the decedent's unused GST exemption, *i.e.,* when the IRC §2032A special use valuation election is made (see §14.45), interest is subtracted from the nonexempt credit trust because the payment of interest to the marital trust does not reduce the amount of GST exemption that may be allocated to the exempt credit trust.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.56A e. Step Six: Determine Which Trusts Receive Net Trust Accounting Income During Administration

§14.56A e. Step Six: Determine Which Trusts Receive Net Trust Accounting Income During Administration

Step six requires a separate calculation of the amount of trust accounting income that has not been distributed to a trust beneficiary during administration. Once this amount is determined, the net trust accounting income must be assigned to one of the trusts. California law provides that a pecuniary gift receives interest under certain circumstances (see §14.44) but does not provide that pecuniary gifts receive any share of trust income during administration. Prob C §§16340, 16341. For a "true worth" date-of-distribution funding formula, all the net trust accounting income is added to the residuary trust. Except for possible interest owed to the pecuniary share for a delay of over a year in funding the pecuniary share, the pecuniary amount is fixed at death and therefore it is the residuary trust that will increase or decrease by the net trust accounting income.

NOTE: In the case of a pecuniary marital/residuary credit trust with date-of-distribution funding, the author's approach builds up the credit trust target and then derives the marital trust target. However, the editor suggests that it is also possible to calculate the marital trust from adjusted gross estate and then derive the credit trust target. In the hypothetical in §14.15, the marital trust target of $1,177,500 (before interest) can be derived by subtracting the decedent's remaining applicable exclusion amount of $3,260,000 from adjusted gross estate of $4,975,000 ($4,750,000 of community property plus $275,000 of nontrust property minus $50,000 of administration expenses deducted on IRS Form 706) and then subtracting $275,000 of nontrust property passing to the surviving spouse and $262,500 of trust property specifically devised to the surviving spouse ($1,715,000 − $537,500 = $1,177,500). In the author's approach, the credit trust target is calculated by adding one-half of net trust accounting income and net principal change (see §14.56B) to the decedent's remaining applicable exclusion amount ($101,250 + $3,260,000 = $3,361,250). The marital trust target is then calculated by subtracting this amount from the decedent's share of the trust ($4,538,750 − $3,361,250 = $1,177,500). The marital trust target is then adjusted by subtracting unpaid expenses deducted on Form 706 ($10,000) and adding paid expenses deducted on IRS Form 1041 ($10,000). See §14.37. In the hypothetical, these two amounts cancel out. The subtrust allocation worksheet in §14.104B and the completed worksheet in §14.104E follow the editor's approach.

In the case of a pecuniary credit/residuary marital trust with date-of-distribution funding, it is not possible to calculate the marital trust directly from adjusted gross estate and then derive the credit trust target because the amount allocated to the marital trust depends on trust income and appreciation during the period of administration. However, the credit trust target may be calculated by adding unpaid expenses deducted on Form 706 to the decedent's remaining applicable exclusion amount and then subtracting paid expenses deducted on Form 1041. This calculation has the effect that trust income and appreciation are not included in the credit trust and so are included in the marital trust. The marital trust target is then derived from the credit trust target by subtraction from the decedent's adjusted share at date-of-allocation values. See Worksheet in §14.104C.

In the case of a fractional share formula, the credit trust target is similarly calculated by adding unpaid expenses deducted on Form 706 to the decedent's remaining applicable exclusion amount and then subtracting paid expenses deducted on Form 1041. However, the appropriate fractional share of trust income and appreciation also must be added to the credit trust target on the basis of a fraction determined by dividing the decedent's adjusted applicable exclusion amount by the decedent's adjusted share at date-of-death values. For these purposes, the IRC §2032A reduction (if applicable) is added to the decedent's remaining applicable exclusion amount. The marital trust target is then derived from the credit trust target by subtraction from the decedent's adjusted share at date-of-allocation values. The same approach may be used with a pecuniary fairly representative date-of-death funding formula. See Worksheet in §14.104D.

If either a credit trust or a marital trust is divided between exempt and nonexempt trusts for generation-skipping purposes, then any income distributed to the residuary credit or marital trust passes through to the residuary exempt or nonexempt credit or marital trust, as the case may be. For example, if, during administration, there was $20,000 of

income that was not distributed to beneficiaries and the marital deduction formula is pecuniary credit/residuary marital and, further, the marital trust is divided between a nonexempt marital trust and a residuary exempt marital trust, the $20,000 income would pass to the exempt marital trust.

If either a fractional share formula or a pecuniary fairly representative date-of-death funding formula is used, the net trust accounting income is proportionately allocated between the marital and credit shares.

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§14.56B f. Step Seven: Determine Which Trusts Receive Net Principal Change During Administration

The seventh step requires a separate review of all sales of trust assets during administration and a calculation netting all capital gains and losses on trust assets sold. To this is added the net appreciation of assets remaining in the trust. From this net amount is deducted any trust accounting principal expenses, yielding a final "net principal change" during administration.

PRACTICE TIP: Step six (see §14.56A) and step seven require a separate calculation of trust accounting income and principal during the administration. During the administration, receipts and disbursements are broken into two components: trust accounting income and trust accounting principal. For example, under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), unless the agreement provides otherwise, interest and dividends are trust accounting income, while capital gains are trust accounting principal. See chap 8. In addition, for example, unless the document provides otherwise, attorney fees and accountants' fees are charged one-half to trust accounting income and one-half to trust accounting principal.

For a "true worth" date-of-distribution funding formula, this final "net principal change" is all added to the residuary trust, which is a function of the pecuniary formula. Except for possible interest owed to the pecuniary share for a delay of over a year in funding the pecuniary share, the pecuniary amount is fixed at death and therefore it is the residuary trust that will increase or decrease by the "net principal change" amount calculated in this paragraph.

NOTE: The calculations in this paragraph are only the decedent's share, not the surviving spouse's share.

If either a fractional share formula or a fairly representative date-of-death funding formula is used, the "net principal change" calculated in this paragraph is proportionately allocated between the marital and credit shares.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.56C 3. Using Spreadsheets to Establish Target Amounts

§14.56C 3. Using Spreadsheets to Establish Target Amounts

Spreadsheets may be used to establish the target amounts that are needed for each subtrust. The worksheets in §§14.104A-14.104D are designed to calculate target amounts based on the formula and funding plan in the trust document, as follows:

- Determining allocation between survivor's share and decedent's share (§14.104A). This worksheet is to be used for all formulas: pecuniary marital/residuary credit with date-of-distribution funding; pecuniary credit/residuary marital with date-of-distribution funding; pecuniary marital/residuary credit with fairly representative date-of-death funding; pecuniary credit/residuary marital with fairly representative date-of-death funding; and fractional share formula.
- Determining subtrust allocations for pecuniary marital/residuary credit formula with date-of-distribution funding (§14.104B).
- Determining subtrust allocations for pecuniary credit/residuary marital formula with date-of-distribution funding (§14.104C).
- Determining subtrust allocations for pecuniary marital/residuary credit formula with fairly representative date-of-death funding; pecuniary credit/residuary marital formula with fairly representative date-of-death funding; or fractional share formula (§14.104D).

For decedents domiciled in common law states or decedents with trusts containing only separate property, portions of the worksheets that involve determining the target for the survivor's share of trust property are not used, because only the decedent's separate property will be subject to administration. By filling in the lines on these worksheets, the user can determine the dollar amount that goes in the various subtrusts, *i.e.*, the "target" amount.

NOTE: Assumptions based on California law are built into these worksheets. To the extent that state law varies from these assumptions, the worksheets will need to be modified. Specifically, it is assumed when using a pecuniary formula that: (1) the pecuniary trust is not entitled to a share of trust income, so that all income may be allocated to the residuary trust as provided by the formula; (2) interest is paid to the pecuniary trust at a rate of 7 percent per year beginning 1 year after the date of death (discussed in §14.44); (3) funeral expenses are the sole responsibility of the decedent; (4) expenses of last illness paid after death are the sole responsibility of the decedent; (5) all administration expenses are the responsibility of the decedent. In a community property state, it can be argued that a portion of the property subject to administrative expenses is the survivor's property, so that a portion of the expenses could be allocated to the survivor; however, in these worksheets, all administrative expenses are allocated to the decedent.

For instructions in using the worksheets, see §14.56D. For an example of using the worksheets to determine share and subtrust allocations for a pecuniary marital/residuary credit formula with date-of-distribution funding, see discussion in §14.56E and completed spreadsheets in §§14.104E-14.104F.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.56D a. Instructions for Using Spreadsheets to Establish Target Amounts

§14.56D a. Instructions for Using Spreadsheets to Establish Target Amounts

The spreadsheets discussed in §14.56C may be used to calculate target amounts for five sets of marital deduction formulas and funding plans by following these instructions:

- *Any Formula.* First, use the worksheet in §14.104A for any formula. Second, use the calculated value of the decedent's adjusted share from the worksheet in §14.104A to complete the worksheets below.
- *Pecuniary Marital/Residuary Credit, Date-of-Distribution Funding.* Insert decedent's adjusted share from §14.104A into worksheet §14.104B, line 78.
- *Pecuniary Credit/Residuary Marital, Date-of-Distribution Funding.* Insert decedent's adjusted share from §14.104A into worksheet §14.104C, line 69.
- *Pecuniary Marital/Residuary Credit or Pecuniary Credit/Residuary Marital, Fairly Representative Date-of-Death Funding.* Insert decedent's adjusted share from §14.104A into worksheet §14.104D, lines 54 and 89.
- *Fractional Share Formula.* Insert decedent's adjusted share from §14.104A into worksheet §14.104D, lines 54 and 89.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.56E b. Example of Using Spreadsheets to Establish Target Amounts for Pecuniary Marital/Residuary Credit Formula With Date-of-Distribution Funding

§14.56E b. Example of Using Spreadsheets to Establish Target Amounts for Pecuniary Marital/Residuary Credit Formula With Date-of-Distribution Funding

The spreadsheets in §§14.104E-14.104F are derived from those in §§14.104A-14.104B, respectively, by inserting numerical values based on the hypothetical in §14.15 and show calculated values of target amounts for shares and subtrusts in a community property state for a pecuniary marital/residuary credit formula with date-of-distribution funding as discussed in §§14.56C-14.56D. The inserted values are taken from Exhibit P (§14.100) and the calculated values are plugged back into Exhibit P. (These values are marked, respectively, by numbered and lettered graphic objects in the worksheets in §§14.104E-14.104F and in Exhibit P to show the relationship between these spreadsheets.) In this example, the marital trust is divided between a pecuniary exempt marital trust (for which a reverse QTIP election will be made on the IRS Form 706 estate tax return) and a nonexempt marital trust. Based on the hypothetical, the spreadsheets are used calculate the targets for the survivor's trust, the pecuniary exempt marital trust, the nonexempt marital trust, and the credit trust by the following steps.

- Calculate the value of the property subject to allocation at date of allocation (Step 1 in worksheet in §14.104E). Insert in line 83 value from Exhibit P, column (13), row 53 (Value 1).
- Calculate the decedent's and survivor's respective shares of the trust (Step 2 in the worksheet in §14.104E). Insert value in Exhibit P, column (10), row 53 (Value A).
- Calculate the adjusted applicable exclusion amount (Step 1 in the worksheet in §14.104F).
- Calculate the decedent's adjusted share as of date of death (Step 2 in the worksheet in §14.104F). Insert in line 33 value from Exhibit P, column (1), row 62 (Value 2).
- Calculate the marital trust target amount (Step 3 in the worksheet in §14.104F).
- Calculate the credit trust target amount (Step 4 in the worksheet in §14.104F). Insert value in Exhibit P, column (11), row 53 (Value B).
- Calculate the pecuniary exempt marital trust target amount (Step 5 in the worksheet in §14.104F). Insert value in Exhibit P, column (12), row 53 (Value C).
- Calculate the nonexempt marital trust target amount (Step 6 in the worksheet in §14.104F). Insert value in Exhibit P, column (12), row 53 (Value D).

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.56F c. Mathematical Analysis of Target Calculations

§14.56F c. Mathematical Analysis of Target Calculations

For the mathematically inclined, the target calculations reflected in §§14.104A-14.104F can be represented by the following equations.

(1) CT = AEA + 2032A reduction + (1 − n) × [Trust Income and Appreciation] + Unpaid 706 Expenses − Paid 1041 Expenses

(2) MT = DOA − CT

(3) DOA = DOD + Trust Income and Appreciation − Paid Expenses

(4) Interest Paid =.07 × [(m − 12)/12] × Pecuniary Amount

In the above equations, CT is the credit trust target and MT is the marital trust target, before payment of interest on the target amount, DOA is the date-of-allocation value and DOD is the date-of-death value of trust assets allocated to the decedent's share, m is the number of months after death when funding occurs, and n is a number between 0 and 1.

Pecuniary Marital/Residuary Credit Formula With Date-of-Distribution Funding. In the case of a pecuniary marital/residuary credit formula, n = 0 because trust income and appreciation are allocated to the credit trust. In this special case, the marital trust target (MT) can be calculated directly by substituting for DOA and CT as follows:

(5) MT = DOD + Trust Income and Appr. − Paid Expenses − CT

(6) MT = DOD + Trust Income and Appr. − Paid Expenses − [AEA + 2032A reduction + Trust Income and Appreciation + Unpaid 706 Expenses − Paid 1041 Expenses]

(7) MT = DOD − AEA − 2032A reduction − Paid Expenses − Unpaid 706 Expenses + Paid 1041 Expenses

(8) MT = DOD − AEA − 2032A reduction − Paid 1041 Expenses − Paid 706 Expenses − Unpaid 706 Expenses + Paid 1041 Expenses

(9) MT = DOD − AEA − 2032A reduction − [Paid 706 Expenses + Unpaid 706 Expenses]

(10) MT = DOD − AEA − 2032A reduction − 706 Expenses

(11) Marital Trust = MT + Interest Paid on Pecuniary Amount

(12) Credit Trust = DOA − Marital Trust

Pecuniary Credit/Residuary Marital Formula With Date-of-Distribution Funding. In the case of a pecuniary credit/residuary marital formula, n = 1 because trust income and appreciation are allocated to the marital trust. In this case, the marital trust target must be calculated from the credit trust target according to equations (1) and (2) as follows:

(13) CT = AEA + 2032A reduction + Unpaid 706 Expenses − Paid 1041 Expenses

(14) Credit Trust = CT + Interest Paid on Pecuniary Amount

(15) Marital Trust = DOA − Credit Trust

Fractional Share Formula/Pecuniary Marital or Pecuniary Credit Formula With Fairly Representative Funding. In the case of a fractional share formula or a pecuniary formula with fairly representative funding, no interest is paid on the credit trust target amount, trust income and appreciation are apportioned between the marital trust and the credit trust, and (1 − n) is equal to the base amount to be allocated to the credit trust divided by the date-of-death value of the decedent's share as follows:

(16) n = 1 − [AEA + 2032A reduction]/DOD

In this case, the marital trust target is calculated from the credit trust target and the credit trust target is calculated by substitution for (1 − n) as follows:

(17) CT = AEA + 2032A reduction + (1 − n) × [Trust Income and Appreciation] + Unpaid 706 Expenses − Paid 1041 Expenses

(18) CT = AEA + 2032A reduction + ([AEA + 2032A reduction]/DOD) × [Trust Income and Appreciation] + Unpaid 706 Expenses − Paid 1041 Expenses

(19) Credit Trust = CT

(20) Marital Trust = DOA − Credit Trust

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.57 G. Allocate Assets Between Subtrusts or Shares

§14.57 G. Allocate Assets Between Subtrusts or Shares

Once the targets are established, the assets should be allocated to the respective subtrusts. In completing allocation of assets, consider the following general factors:

- **Nonprorata allocation of community property between surviving spouse's half and deceased spouse's half.** Allocation of the surviving spouse's separate property to the credit trust or marital trust causes a taxable event. On the other hand, a nonprorata allocation of the deceased spouse's half of the community property to the credit or marital trust is not a taxable event unless the trust document prohibits such an allocation; most trust documents allow a nonprorata allocation and, if the document is silent, the allocation is allowed by California statute. Prob C §16246. A nonprorata allocation of either spouse's half of the community property to the other spouse's trust, however (*e.g.,* allocating the entire community property family residence to the survivor's trust), may be a taxable event. See §14.58.
- **Timing of funding of assets between subtrusts.** Whether the practitioner should fund assets quickly or slowly into the subtrusts depends on various factors, such as (1) the marital deduction formula or GST tax formula used in the trust instrument; (2) whether one trust is going to buy back assets from another trust; and (3) whether there are more advanced estate planning techniques anticipated that will require a quick funding.

As discussed in §§14.31 and 14.46, in the funding of a pecuniary formula trust, whether with a marital deduction formula or a generation-skipping transfer (GST) tax formula, allocating assets in kind to satisfy the pecuniary amount at date-of-distribution values creates capital gains. Because assets other than IRD receive a step-up in basis for community property, funding should take place very soon after death to avoid possible capital gains if an asset appreciates between date of death and date of distribution. On the other hand, there can also be a step-down in basis for depreciated assets and funding could be delayed to avoid future capital gains that might occur if an asset depreciates further between date of death and date of distribution.

For example, assume a marital deduction formula of pecuniary credit/residuary marital, date of distribution funding, and a total community property estate of $7 million or less. If the first death takes place in 2009, any assets that appreciate in value from the date of death to the date of distribution will produce capital gains on funding into the credit trust. It is therefore imperative that the credit trust amount of $3.5 million be funded immediately after death to avoid the potential capital gains. On the other hand, if the marital deduction is pecuniary marital/residuary credit, date of distribution funding, the practitioner may well want to wait up to 15 months (the date that raises generation-skipping transfer (GST) tax issues discussed in §14.56) so that all appreciation from the date of death will be added to the residuary credit trust. But if there is a down market when stocks or other assets are declining in value, consider funding quickly to avoid having a loss borne by the residuary credit trust.

As discussed in §14.59, the survivor's trust may be purchasing the credit or marital trust's interest in the family residence, which purchase is a taxable event. If the purchase is done immediately after death when there is a step-up in basis, there will be no capital gains tax incurred.

Under certain facts, sophisticated estate planning may be called for and, therefore, require quick funding of assets. For example, when there is an elderly surviving spouse and the residence was community property, the author frequently uses a qualified personal residence trust (QPRT); because the surviving spouse must live the term of the QPRT in order for the QPRT to be effective, the family residence should be allocated to the survivor's trust immediately and then immediately put into a QPRT to start the running of the QPRT term. For further discussion of this technique, see §14.115.

NOTE: It is important to note that the allocation of assets to subtrusts does not have to be done all at one time; it can be done asset by asset over the period of the administration.

- **Surviving spouse's income needs.** If the credit trust does not provide for mandatory income to the surviving spouse because the surviving spouse was not expected to need the income, consider whether non-income-

producing property should be allocated to the marital trust and income-producing property allocated to the credit trust to allow accumulation of income in the credit trust. This will increase the amount passing free of estate tax at the second death. If the credit trust provides for mandatory income, consider advising the surviving spouse to disclaim the income interest to achieve the same result. In weighing these options, the income tax effect of accumulating income should be taken into account.

- **Appreciating assets.** A common theory of funding is to allocate appreciating assets to the credit trust, because the appreciation will not be subject to tax at the second death.
- **Consider basis step-up at second death.** Consider that assets in the credit trust will not receive a step-up in basis at the second death, unlike marital trust assets.

PRACTICE TIP: The author frequently makes the allocation with the client present with a computer spreadsheet filled out, but without any allocation of assets to the various subtrusts. Consider having the CPA and the stock broker or financial adviser present as well, or providing for their participation in the process. Each professional may have different advice regarding asset allocation.

In making the allocations, special considerations should be taken into account with respect to certain assets. On the relevant issues regarding some commonly encountered assets, see §§14.59-14.67.

For a completed asset allocation spreadsheet reflecting the hypothetical used in this chapter, see Exhibit P in §14.100. Exhibit S in §14.103 shows in text format the formulas used in the sample spreadsheet in Exhibit P.

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§14.58 1. Nonprorata Allocation of Community Property Assets

Nonprorata allocation of either spouse's half of the community property to the other spouse's trust (*e.g.,* allocating the entire community property family residence to the survivor's trust) may be a taxable event, although the IRS's position is uncertain.

In California, the trustee has the power to make nonprorata distributions of property, and a husband and wife may agree in writing that community or quasi-community property may be divided at death on a nonprorata basis. Prob C §§16246, 100-101. These statutes also specifically allow the adoption of the aggregate theory of community property (half of the whole) with assets held in trust. Probate Code §104.5 provides that the transfer of community or quasi-community property assets to a revocable trust is presumed to be an agreement that those assets will retain their character in the aggregate. The hope is that these sections minimize any risk that such a division might result in a sale or exchange, but it is still uncertain whether the IRS agrees with this position.

Two older private letter rulings seem to imply that this kind of allocation is not a taxable exchange. IRS Letter Rulings 8016050 and 8505006, relying on Rev Rul 76-83, 1976-1 Cum Bull 213. Some commentators believe that the reasoning in these letter rulings is flawed because Rev Rul 76-83 concerned a case involving dissolution, not death, and because the IRS seemed to apply the item theory of community property (as opposed to the aggregate theory in states like Arizona and New Mexico), in which each spouse has an undivided community interest in each and every community property asset, rather than one-half of the aggregate.

The IRS raised this issue again in a series of Northern California audits in the early 1990s. The audits were eventually dropped at the direction of the National Office, and indications are that the IRS will not pursue this issue. The author has not heard of this issue being raised by the IRS since the 1990s.

In IRS Letter Ruling 199912040, 100 percent of a community property IRA, which named the revocable trust as a beneficiary, was allocated to the survivor's trust while an equivalent amount of other community property assets was allocated to the bypass trust. The ruling held there was no gain or loss on the nonprorata allocation of trust assets. See also IRS Letter Ruling 199925033. Both of these letter rulings were California cases; both approved a nonprorata allocation of community property.

These rulings, as well as the statutory provisions discussed above, give important support to the nonprorata allocation of community property. Most practitioners feel comfortable advising clients that a nonprorata allocation of community property is not a taxable event, while advising clients in writing of the possibility that the IRS will assert the contrary position. More cautious practitioners simply refuse to do nonprorata allocations of appreciated community property assets, which the IRS could categorize as a taxable event.

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2. Specific Types of Assets

§14.59 a. Family Residence and Vacation Home

An interest in a personal residence allocated to the marital or credit trust will not qualify for the biannual exclusion of gain from sale of a principal residence ($250,000 for a single person; $500,000 for a married individual filing jointly). To qualify for this exclusion, the property must be owned and used by an individual as the individual's principal residence for 2 of the 5 years preceding the sale, and the exclusion is reduced proportionally for periods of nonqualified use preceding the last period of qualified use within the 5-year period. IRC §121. However, a surviving spouse qualifies for the $500,000 exclusion on property allocated to the survivor's trust provided that the survivor meets the use condition and the sale occurs not later than 2 years after the death of the deceased spouse. IRC §121(b)(4). In addition, if the residence is in the credit trust, it may be impossible to deduct the interest on an acquisition or home improvement loan totaling up to $1 million, or up to $100,000 on other loans when the loan is secured by the personal residence. IRC §163(h)(3).

Aside from the tax issues, the surviving spouse often wishes, for personal reasons, to own the family residence entirely in the survivor's trust. When the family residence is community property, achieving this goal may require a nonprorata allocation or postallocation sale or exchange. Consider the fact that putting the residence in an irrevocable trust (*e.g.*, credit trust) precludes the surviving spouse from creating a qualified personal resident trust (QPRT). IRC §2702.

Most surviving spouses also prefer to have a vacation or second home in the survivor's trust. Such an allocation allows for the possibility of a QPRT and gives the survivor more control over its use.

NOTE: In some situations, the credit trust is the only place to put all or a portion of the family residence. One possible solution is to sell the credit trust's interest in the family residence to the survivor's trust and have the credit trust take back a promissory note, secured by the interest in the residence. If this is done quickly after the first death (and assuming the residence is community property), there will be no gain even though it is a taxable event, because the property received a step-up in basis at death. A separate issue is whether taking back a note is a proper investment for the credit trust. See Lamping, *A House Divided: The Purchase by the Surviving Spouse of an Interest in the Family Residence Following its Allocation to Credit Trust*, 14 Cal Trusts & Estates Q 42 (Fall 2008).

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§14.60 b. Loans to Children

It is not uncommon for the revocable family trust to include promissory notes from children of the settlors. As most practitioners know, children often borrow from their parents and seldom repay them. If such obligations are allocated to the credit trust or marital trust, the surviving spouse/trustee has a fiduciary duty to enforce them, or risks a breach of trust claim by the other children or other beneficiaries. Although a child would probably not sue a parent during the parent's lifetime, a child might sue a successor trustee after the surviving spouse's death if the obligation has not been barred by the statute of limitations. To avoid this problem, consider allocating such notes to the survivor's trust.

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§14.61 c. Assets Subject to Guaranties

If an asset is subject to a guaranty (such as stock of a closely held business) consider whether that asset should be allocated to the credit trust. In IRS Letter Ruling 9113009, the IRS took several questionable positions on the effect of guaranties on estate and gift tax obligations. In the ruling, the taxpayer had guaranteed the obligations of corporate entities owned by his children and had also made personal guaranties for businesses in which he owned an equity interest. The IRS ruled that the taxpayer's guaranties for his children's businesses were present taxable gifts to his children of an economic benefit (either the amount of the guaranties or at the very least the benefit of lower interest rates), valued as of the time the guaranties were executed. The IRS also ruled that the taxpayer's marital deduction was reduced by the face amount of the guaranties outstanding at his death. Moreover, the taxpayer's QTIP trust would fail to qualify for the marital deduction to the extent that the guaranties could be satisfied from the assets of his trust.

This letter ruling was restricted by IRS Letter Ruling 9409018, which indicated that the marital deduction is not reduced by the entire unpaid balance of the guaranteed loans unless (1) at the time of the taxpayer's death, after the marital trust is funded, a default is likely; (2) trust assets will be used to pay outstanding loan obligations; and (3) subrogation rights appear to be worthless. The IRS left open the question whether the marital deduction must be reduced by the "value" of the guarantee.

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§14.62 d. IRD Items

If possible, avoid using assets that are income in respect of a decedent (IRD) to satisfy a pecuniary bequest, because doing so will trigger acceleration of income. See Treas Reg §1.1014-4(a)(3). But see Choate, Life and Death Planning for Retirement Benefits, pp 348-350 (6th ed 2006) (arguing that there will be no acceleration of income). In IRS Legal Memorandum 200644020, the IRS contended that funding pecuniary charitable gifts with shares of the decedent's IRA resulted in the distributing trust recognizing income under IRC §691(a). The IRS contended that this "transfer" characterization is supported by *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217, in which the court concluded that satisfaction of a pecuniary devise with property other than cash is treated as a sale of the property. In contrast, a nonprorata allocation of IRAs to fractional shares of a trust residue passing to charity are not a disposition of IRD that causes income to be taxed to the trust. IRS Letter Rulings 200652028, 200633009.

In a taxable estate, an important issue is the relationship between the inclusion of IRD as part of the estate tax and the income tax deduction under IRC §691(c), which is intended to approximate the impact of estate tax on the income tax imposed under IRC §691(b). Because §691(c) provides a deduction rather than a credit for estate tax paid, however, to some extent there will still be a double tax.

NOTE: Items of IRD received by the trust and properly included in the trust's gross income are included in the estate's distributable net income (DNI) under IRC §643(a) and used to determine the estate's maximum IRC §661 income distribution deduction for distributions of cash to beneficiaries in the same year. To the extent the estate is allowed distribution deductions, the income is taxed to the distributees. See IRS Legal Memorandum 200644016. For further discussion, see §11.25.

In the context of asset allocation in funding the subtrusts, there is usually no estate tax and thus no corresponding income tax deduction. It is the acceleration of income on the funding that should be avoided. See *Estate of Cherry* (WD Ky 2001) 133 F Supp 2d 949 (when marital share bears burden of estate taxes, calculation of difference between estate tax actually paid and estate tax that would be owed if IRD had not been included in estate must take into account reduced marital deduction that would result from not including IRD in marital gift).

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§14.63 (1) Definition of IRD

Internal Revenue Code §691 and Treas Reg §1.691(a)-1(b) define IRD only in general terms. The courts have defined it more specifically. In *Estate of Charley W. Peterson* (1980) 74 TC 630, 639, aff'd (8th Cir 1981) 667 F2d 675, the court set forth the following four-part test for detecting items of IRD:

- The decedent must have "entered into a legally significant arrangement" regarding the subject matter of the sale;
- The decedent must have "performed the substantive (nonministerial) acts required of [the decedent] as preconditions to the sale";
- There must not have existed at the time of the decedent's death any "economically material contingencies which might have disrupted the sale"; and
- The decedent must have "eventually received (actually or constructively) the sale proceeds if [the decedent] had lived."

But see Rev Rul 82-1, 1982-1 Cum Bull 26, which appears to reject the "delivery" test above.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.64 (2) Examples of IRD

§14.64 (2) Examples of IRD

IRD items generally fall into one of the following four categories:

Compensation. Examples include:

- Compensation earned but not received before death;
- Vacation pay, sick pay, and similar allowances due at death;
- Unpaid deferred compensation payable to the employee;
- Voluntary payment by employer to the deceased employee's estate or family;
- Qualified employee benefits;
- Partnership income attributable to a predeath period (current distributive share);
- Postdeath realization of partnership receivables;
- Receivables due for services, *e.g.,* commissions, professional fees;
- Statutory stock options;
- Insurance renewal commissions;
- Fiduciary fees earned but not received;
- Director fees earned but not received; and
- Any postdeath bonus to be paid to the employee with substantial certainty (but which the employer is not under a legal obligation to pay).

Investment income. Examples include:

- Interest income accrued through date of death;
- Nonrecognized gain on U.S. Savings Bonds;
- Dividends declared before death (*i.e.,* death occurs after the record date but before payment);
- Rental income accrued to the date of death; and
- Royalties attributable to a predeath period.

Sale proceeds. Examples include:

- IRC §736(a) payments;
- Installment obligations; and
- Executory contracts.

Other. Additional items of IRD that fit no particular category include:

- Trust or estate income distributed to a beneficiary after the beneficiary's death;
- Damage claims;
- Alimony arrears;
- Medical reimbursement rights;
- Individual retirement accounts; and
- Copyright payments, patent royalties.

See Acker, *Income in Respect of a Decedent*, 862-2d Tax Management Portfolios, Worksheet 9 (2003).

NOTE: The three categories of IRD that most often cause funding problems are retirement benefits, investment income, and sale proceeds.

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§14.65 (3) Retirement Benefits

One of the most difficult issues is dealing with retirement plan benefits, which are a major IRD item. If the nonparticipant spouse dies first, the issue is whether it is possible to fund the credit trust with assets representing that spouse's community property interest in the survivor's retirement plan, whether a qualified or nonqualified plan.

In *Boggs v Boggs* (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754, the United States Supreme Court held that the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461) preempts the community property interest in a qualified plan held by the nonparticipant spouse at death. See also *Egelhoff v Egelhoff* (2001) 532 US 141, 149 L Ed 2d 264, 121 S Ct 1322. ERISA does not preempt the nonparticipant spouse's community property interest in a nonqualified IRA. See IRS Letter Ruling 199937055. *Boggs* appears to preclude funding the credit trust with assets representing the nonparticipant spouse's community property interest in the survivor's qualified plan. The credit trust may, however, be funded with assets representing the nonparticipant spouse's community property interest in the survivor's IRA because ERISA preemption does not apply.

Another problem arises when an IRA is used to fund a QTIP trust. In IRS Letter Ruling 200644022, the IRS ruled that the successor beneficiary of a trust was not the "designated beneficiary" of a surviving spouse trust beneficiary who did not receive minimum required distributions because she died before attaining age 70½. Accordingly, the IRS ruled that an IRA that was treated as belonging to the surviving spouse for minimum distribution purposes because the spouse had the power to compel distributions of IRA income must be distributed within 5 years of the surviving spouse's death. The ruling has the troublesome implication that an IRA that names a QTIP trust as a beneficiary (or any other trust that is a "conduit trust" because distributions are made only to the primary beneficiary during the life of that beneficiary) will not have a designated beneficiary when the spouse dies. At least in the usual case, the spouse will have no power to designate her own successor beneficiary. If the participant spouse had wanted to permit the nonparticipant spouse to name a successor beneficiary, the participant presumably would have named the spouse, rather than the trust, as the primary beneficiary—thereby enabling the spouse to roll over the IRA into an IRA for the spouse.

On the other hand, the IRS has been quite liberal in allowing a spousal rollover of an IRA that names the participant's revocable trust as a beneficiary when the spouse is the fiduciary having the power to make the allocation of trust assets in a way that results in the IRA distributions passing to the spouse (see IRS Letter Ruling 200615032) or a trust reformation gives the spouse the power to withdraw the IRA distributions from the trust (see IRS Letter Ruling 200704033).

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§14.66 e. Special Use Valuation Property

Special use valuation (see IRC §2032A) may be available at the first death, even in a zero-tax estate; if so, the credit trust can be "packed" to take advantage of a higher effective estate tax exemption as follows: For death in 2007, $2,940,000 effective exemption ($2,000,000 exemption plus $940,000 §2032A reduction); for death in 2008, $2,960,000 effective exemption ($2,000,000 exemption plus $960,000 §2032A reduction); and for death in 2009, $4,500,000 effective exemption ($3,500,000 exemption plus $1,000,000 §2032A reduction).

At its most advanced, this technique is employed if the instrument uses a true worth pecuniary marital formula. If a reverse pecuniary formula is used, the reduction in value inures to the marital share. If a fractional share formula is used, "packing" is only partially used.

In *Simpson v U.S.* (D NM 1992) 92-2 USTC ¶60,118, the court allowed the trustee to use fair market value in funding the marital trust with stock of a closely held farming corporation, although special use value was used to calculate the marital share, the effect of which was to pack the credit share with a larger percentage. The court held that, when the trustee had the sole discretion to fund the marital deduction trust, the IRS had no standing to set the amount of special use valuation stock required to fund the trust. See IRS Letter Ruling 9407015. But see IRS Letter Ruling 8422011 (special use value, not fair market value, must be used in valuing outright bequest, as opposed to formula marital bequest of special use property to surviving spouse). See generally Zumbach, Reames & Tausner, *Section 2032A—Special Use Valuation*, 833-2d Tax Management Portfolios (2003).

For GST exemption allocation purposes, fair market value must be used rather than special use value, unless the IRC §2032A(d)(2) recapture agreement provides for recapture of GST tax. Treas Reg §26.2642-2(b)(1). Assets of greater value may be transferred to direct skips without incurring GST tax by using the special use value rather than fair market value. This can be accomplished by using a formula based on the maximum amount that can be transferred without incurring GST tax (either drafted in the estate planning documents or in a disclaimer) to determine the value of property to be transferred to the direct skip person or persons. For example, in 2009, in an estate with a net value of $7,500,000 (based on special use value; $8,500,000 based on fair market value) and total estate taxes of $1,800,000, by using special use value in determining the GST exemption amount, 52.94 percent ((1,000,000 + 3,500,000) ÷ 8,500,000) of the net value (before payment of estate taxes) can be transferred to direct skips, effectively transferring $4,500,000 of assets (valued at fair market value) or $3,547,080 after payment of a prorata share of estate tax. If, on the other hand, fair market value is used in determining the GST exemption amount, then only 41.17 percent (3,500,000 ÷ 8,500,000) of the estate may be transferred free of GST tax, representing $3,500,000 in assets or $2,758,823 after payment of a prorata share of estate tax. The net result of using special use valuation to determine the GST exemption amount is the transfer of an additional $1,000,000 in assets to direct skips or $788,256 after payment of estate tax.

When determining whether the estate satisfies the 25-percent test (25 percent of the estate must consist of special use real estate) and 50-percent test (50 percent of the estate must be composed of, *e.g.,* the farm business, farm land and improvements, equipment, crops in storage, crop receivables), both halves of community property real estate can possibly be treated as if owned by the decedent spouse. IRC §2032A(e)(10).

PRACTICE TIP: In allocating assets between trusts at the first death, care should be taken to qualify the surviving spouse's estate for the IRC §2032A election. In other words, with proper planning, it may be possible to use this provision on both the first death and on the second death. Using this provision in both estates, it is possible to pass as much as $9 million tax-free on the surviving spouse's death, assuming the first death is in 2009 and the second death also in 2009.

NOTE: Section 2032A is not limited to farm or ranch property; it can also apply to a trade or business, and should be considered in those situations.

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§14.67 f. Other Assets

S corporation stock. Make certain that the trust proposed to receive an allocation of S corporation stock qualifies as a qualified Subchapter S trust, or electing small business trust. If the stock produces high income, allocation of this asset to the survivor's trust would allow its use in a GRAT.

Section 303 stock. If any estate tax is to be paid at the first death, it must be paid from the credit trust to avoid marital deduction problems; IRC §303 stock should therefore be allocated to the credit trust.

Closely held business or nonproductive real estate. If the surviving spouse is inactive in the business, or if the trust estate includes raw land held for development or other non-income-producing assets, remember that the QTIP rules (see IRC §2056(b)(7)) require the survivor to have the power to make assets productive by demand on the trustee.

Unmatured life insurance. Any unmatured life insurance on the life of the surviving spouse or others should generally be allocated to the credit trust; otherwise, proceeds would be taxed on the survivor's death. Make sure, however, that the trust instrument provides for a special trustee (if the surviving spouse is the sole trustee); otherwise, the surviving spouse may have incidents of ownership over the trust, with the result that policy proceeds will be included in the surviving spouse's estate at the second death.

Dividend reinvestment accounts. If stocks are in a dividend reinvestment program, the assets should not be allocated to a trust from which income distribution is mandatory, because it will be difficult, if not impossible, to determine what income should be distributed.

Qualified conservation easements. An exclusion is allowed from the gross estate of up to 40 percent of the value of land subject to a qualified conservation easement. IRC §2031(c)(1)-(2). The excludable amount is $500,000. There are no geographic limitations to the use of a qualified conservation easement. IRC §2031(c)(8). If an election is made on IRS Form 706, the amount funded into the credit trust could be increased by the amount of the exclusion.

Funding marital deduction or GST formula. As discussed in §§14.31 and 14.46, the funding of certain formulas may create capital gains. If such a formula exists in a case, an asset that has increased in value should be funded into the nonpecuniary "back" trust.

Income property. If a property is producing high income in relation to its value, all or a part of such property should be considered as a candidate for the survivor's trust in order to fund it into a GRAT.

Assets subject to options or buy-sell agreements. Because of potential marital deduction problems, assets subject to options should be allocated to the credit trust. See IRS Letter Ruling 9139001; but see also IRS Letter Ruling 199951029, in which stock subject to a right of first refusal at its fair market value as determined by an independent appraisal did not affect the QTIP election.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.68 3. Discount Planning

§14.68 3. Discount Planning

Discount planning that occurs at the time of funding affects the discounts available on the deceased spouse's death and on the surviving spouse's death, and can affect the amount of assets allocated to particular subtrusts. Related issues include how to report the discounts on the IRS Form 706 return and the effect of the discount on a step-up in basis. There are four potential related issues concerning discount planning involving many related subtrusts (see §§14.69-14.78):

- How the value should be shown on the Form 706 return;
- What value is used for basis calculation;
- What value is used in funding subtrusts at the first death; and
- What discount is available on the death of the surviving spouse.

NOTE: The term "discount" is probably a misnomer because it implies that the fair market value is reduced by some "discount," when in reality the fair market value is the reduced value. A more appropriate term would be "adjustment."

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§14.69 a. Reporting on IRS Form 706 Return

Under California community property law, each spouse owns an undivided one-half interest in each community asset. See Prob C §100(a). Case law has held that fractional interest discounts apply to the community half of an asset owned by each spouse. See, *e.g.*, *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248. Therefore, in a taxable situation, *e.g.,* when half of a community property real property asset appraised at $2 million is devised to children, most practitioners would obtain an appraisal and discount the $1 million devised to the children by at least 15 percent, reporting $850,000 on IRS Form 706. The answer is to be found in §§14.70-14.71. If, however, there is no tax on the first death, the question, under the same facts, is whether to report $1 million or $850,000 on Form 706. Note that the value on Form 706 is the fair market value in the hands of the decedent, without regard to the identity of the transferee. See IRC §2031.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.70 (1) Discount on Community Property Interest

§14.70 (1) Discount on Community Property Interest

Several IRS estate tax examiners, on auditing IRS Form 706 at the first death, require a discount of at least 15 percent for the decedent spouse's one-half community property interest. One such case involved a $1.2 million estate of a married decedent who had a formula marital deduction estate plan. After applying the marital deduction, the estate tax return showed a taxable estate of less than $600,000 and no tax due. The estate assets included only community property half interests in real property. The examiner proposed a 15-percent reduction of the reported values of the real property to reflect the fractional share discount. Examination of April 12, 1995. See 16 CEB Est Plan Rep 154 (June 1995). The author is aware of other cases in which the examiners have demanded such discounts, particularly in the Northern California District. The author, having been advised that the IRS intends to consistently take this position, believes that the IRS is correct to do so. If the same one-half community property interest were given to a beneficiary in a taxable situation, almost all practitioners would take some kind of discount.

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§14.71 (2) Practicality of Discounting

The IRS may be correct about the need to discount on IRS Form 706. Nevertheless, few practitioners do so, because the cost of obtaining the required appraisal can be avoided only if the initial appraiser is also willing to make the discount adjustments. Many practitioners, however, understandably fear taking a discount without an independent appraisal. In *Estate of Edgar A. Berg,* TC Memo 1991-279, aff'd in part and rev'd in part (8th Cir 1992) 976 F2d 1163, the court of appeals held that the estate had reasonably relied on a CPA's appraisal; the Tax Court, however, previously had held that the CPA was not qualified to give such an appraisal.

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§14.72 b. Duty-of-Consistency Doctrine

The IRS may well argue that failure to take a discount on the IRS Form 706 return may preclude a discount on the same property on the death of the surviving spouse under the doctrine of duty of consistency. See *Lefever v Commissioner* (10th Cir 1996) 100 F3d 778; *Eagan v U.S.* (1st Cir 1996) 80 F3d 13; *Estate of Mildred Geraldine Letts* (1997) 109 TC 290; IRS Letter Ruling 200407018. See also *Janis v Commissioner* (9th Cir 2006) 461 F3d 1080. But see *Estate of Ruth B. Posner*, TC Memo 2004-112. For further discussion of the duty of consistency in reporting on the second death, see §§14A.14-14A.16.

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§14.73 c. Value for Basis Calculation

Whether community property is reported at full fair market value or at a reduced fair market value reflecting the fractional ownership, the stepped-up basis for income tax purposes should be the same under IRC §1014(b). Arguably, §1014(b) provides that the property acquired from a decedent includes the entire community asset, half under IRC §1014(b)(1) and half under IRC §1014(b)(2). See 16 CEB Est Plan Rep 154 (June 1995). The IRS's clear position, however, is that the income tax basis should reflect the fractional share discount. The possibility of a step-down in basis (when the estate tax value of the property may be less than cost basis because of market decline) beyond the reduction caused by fractional ownership of community property also should be considered. The issue arises in two contexts.

First, there may be cases where it is appropriate to partition selected items of community property before death to avoid a step-down in basis on both halves of the property if it becomes evident that one spouse has a shortened life expectancy. Partition may be combined with a lifetime gift to the remainder beneficiaries of the appropriate subtrust by the spouse with the shortened life expectancy so that basis will be determined under IRC §1015. If IRC §1015 applies, the basis of an asset in the hands of the donee will generally be the same as the basis of the assets in the hands of the donor. Of course, this strategy is not available after the death of the first spouse to die.

Second, when a market decline occurs within 6 months after the first death, it may be appropriate for the surviving spouse to disclaim a small portion of the marital deduction gift to trigger an estate tax on the first death so that the decedent's estate can make an IRC §2032 alternate valuation date election. See §13.35A. A qualified disclaimer requires that the survivor not accept any benefits of the disclaimed portion of the gift during the 9-month period following the decedent's death under IRC §2518, but this should not be a problem when an administrative trust is used. Note that the purpose of making the election in this context has little to do with saving estate tax on the first death. The tax will be near zero in any event and making the election will have the negative consequence of a lower income tax basis for the decedent's share of trust assets (and also for the survivor's share of community property). The election may nevertheless be desirable because of the effect of reduced asset values on the distribution results produced by the formula clause.

If a pecuniary marital/residuary credit formula is used, the credit trust will receive less funding if asset values have dropped and the IRC §2032 election is not made. Assuming that a reduction in the value of the credit trust would be a bad result, an IRC §2032 election will result in a recalculation of the amount of the pecuniary gift passing to the marital trust. The estate tax value of the estate is reduced, with the consequence that the size of the pecuniary marital gift needed to eliminate (or minimize) the estate tax is reduced and the value of the residuary gift allocated to the credit trust is increased.

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d. Value for Funding Subtrusts at First Death

§14.74 (1) Particular Asset to Subtrust

If community property is reported on IRS Form 706 using a discounted value for fractional share ownership, practitioners should consider the effect on the value of property eventually subject to tax in the surviving spouse's estate.

EXAMPLE: Consider a simple estate plan that establishes a survivor's trust and a credit trust on the deceased spouse's death. If the taxable estate includes a one-half community property interest in an $800,000 residence, and that interest is discounted by 15 percent to reflect the fractional ownership, the estate tax value of that interest will be $340,000. If the deceased spouse's interest in the residence is allocated to the survivor's trust, the value of the property belonging to the surviving spouse is increased by $120,000 because the survivor's interest has a value of $340,000 and the combined interests have a value of $800,000 ($340,000 + $340,000 + $120,000 = $800,000). This result may be avoided by allocating both halves of the residence to the credit trust.

In effect, by discounting, it may be possible to leverage the amount allocated to the credit trust. If discounting is appropriate, however, it is unclear whether the IRS could argue the reverse, *i.e.*, that a nonprorata distribution creates a control premium in the subtrust receiving the larger share of the asset. For example, if, instead of allocating a family business one-half to the credit trust and one-half to the survivor's trust, the trustee allocates all of the business to the credit trust and none to the survivor's trust, has the credit trust been overfunded? See *Estate of Dean A. Chenoweth* (1987) 88 TC 1577 (marital deduction). See also *Ahmanson Found. v U.S.* (9th Cir 1981) 674 F2d 761 (estate for charitable deduction).

See also *Estate of Richard R. Simplot* (1999) 112 TC 130, rev'd (9th Cir 2001) 249 F3d 1191, which dealt with allocation of voting and nonvoting stock to subtrusts. The Tax Court assigned a control premium to voting stock contributed to a credit trust. As a result, the credit trust was overfunded and the marital trust was underfunded, because the instrument provided for allocating to the credit trust all of the voting stock plus the additional amount of nonvoting stock necessary to fully fund the trust, and the value of the voting stock exceeded the applicable exclusion amount. This decision was reversed in *Simplot v Commissioner* (9th Cir 2001) 249 F3d 1191 and remanded by the Ninth Circuit Court of Appeals, but it is uncertain whether this remand reverses the Tax Court's finding. See also *Estate of Frank M. DiSanto,* TC Memo 1999-421 (when decedent owned controlling interest in corporation, but only minority interest passed to spouse, value of marital deduction allowed for stock passing to spouse was its minority interest value).

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§14.75 (2) Effect on Marital Deduction Funding

An asset's value for funding purposes is different from its value for estate tax purposes. Specifically, in the marital deduction context, a marital deduction is available only for the value of what passes to the surviving spouse or the marital trust. If what is passing is a fractional or minority interest, is a valuation discount necessary or appropriate? In IRS Letter Ruling 9403005, in dividing the deceased spouse's separate property, the marital share was calculated using fair market value, but the IRS required a discount in the value of a minority interest funded into the marital trusts and assessed an estate tax on the first death when there would otherwise have been no tax. In other words, it is the IRS's position that there is no symmetry between the gross estate and the marital deduction value. But see *Provident Nat'l Bank v U.S.* (3d Cir 1978) 581 F2d 1081 (marital deduction).

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§14.76 (3) Self-Adjustment by Formula

Even if the IRS's position of requiring a discount for a community property interest is correct, as long as the QTIP election on IRS Form 706, Schedule M, is made on a formula basis, and as long as there is an allocation agreement requiring the trustee of the marital trust and the trustee of the credit trust (likely to be the same person, *i.e.*, the surviving spouse) to adjust their respective shares if subsequent valuation adjustments occur, there should be no adverse estate tax effect, because the marital deduction formula (regardless of the type of formula) automatically adjusts the shares to take into account valuation adjustments on audit.

NOTE: In IRS Letter Ruling 9116003, it was declared that the executor was not required to list assets that she intended to use to fund the marital gift.

If the deceased spouse's share has insufficient assets to make the adjustment, the IRS may be right, and there will be a tax on the first death. This apparently was the result in IRS Letter Ruling 9403005. Even if assets are insufficient to make the adjustment, however, if the marital deduction on Schedule M of the return was calculated with a formula and there was an asset allocation agreement (see §14.84), there is no reason why an adjustment could not be made at audit of the 706, by increasing the percentage of, for example, a property in the marital trust and reducing the percentage of that property in the credit trust.

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§14.77 (4) Guidelines on Use of Discounts

Funding marital share with community property. When community property is used to fund a marital deduction amount, the value of the gross estate and the marital deduction funding amount should be the same, because the one-half interest is already a fractional interest.

Swing premium: If one must fund the marital deduction in kind with a fractional interest, consider adding a swing premium to the minority interest.

Allocation of minority interest. If the deceased spouse's share of a business is a controlling interest, a minority interest should not be allocated to the marital deduction share. If the deceased spouse owns property as his or her sole and separate property, do not leave this to the surviving spouse, but use a fractional share funding formula.

Sale of assets. If any assets are subject to possible taxes on the first death because of discount funding issues, consider selling those assets before funding the various subtrusts.

Discount on death of surviving spouse. The way subtrusts are funded on the first death may affect what discounts can be taken on the surviving spouse's death. If an asset is split between the credit trust and a trust includable in the surviving spouse's estate at his or her death (the marital or survivor's trust), clearly there is a discount on the second death. *Estate of Eleanor O. Pillsbury,* TC Memo 1992-425.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.78 (5) Aggregation of Interests

§14.78 (5) Aggregation of Interests

There is no aggregation of interests for purposes of valuing trusts includable in the surviving spouse's taxable estate if the marital deduction trust is a QTIP trust. *Estate of Harriett R. Mellinger* (1999) 112 TC 26, acq 1999-2 Cum Bull 763.

NOTE: IRS Field Service Advice 200119013 and *Estate of Aldo H. Fontana* (2002) 118 TC 318 state that the rule in *Mellinger* does not apply if the surviving spouse has a general power of appointment over the marital trust. Therefore, the portion of the property held in the general power of appointment trust can be aggregated with the portion of the property held outright by the decedent spouse or in the survivor's trust. In some cases, corporate stock aggregated with stock owned by the spouse may be valued with a control premium. However, the amount of any charitable deduction may be limited by the value of the minority interest appointed to charity. See IRS Letter Ruling 200648028. Cases cited by the IRS in support of this conclusion include *Estate of Dean A. Chenoweth* (1987) 88 TC 1577, discussed in §14.74.

PRACTICE TIP: There are some planning opportunities concerning aggregation. The following are ways to avoid aggregation, one of which is done at the drafting stage while others must be implemented on the funding of the subtrust on the first death, and still others may be done post funding:

(1) Use a QTIP trust as the marital deduction trust.

(2) Allocate the fractional interest to the credit trust, assuming, of course, that this does not lower the value of the assets allocated to the point that the marital deduction gift cannot be fully funded.

(3) Make a QTIP election for less than 100 percent of the marital trust.

(4) Have the surviving spouse make an inter vivos gift of his or her own assets.

(5) Have the surviving spouse assign his or her income interest in the marital trust.

(6) Have the surviving spouse or the marital trust sell or exchange assets.

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§14.79 4. Estate Freezing

Asset allocation after the death of the first spouse creates an opportunity to effect a freeze without running afoul of IRC §2702 (governing grantor retained interest trusts). Consider allocating the preferred stock of a closely held business to the survivor's trust or marital trust and the common stock to the credit trust. This allocation should not trigger §2702, because the surviving spouse does not make a transfer or retain property within the definition of that section. See Treas Reg §25.2702-2(d)(1), Example 3; Pennell, Estate Tax Marital Deduction, 843-2d Tax Management Portfolios, p A-126 (2005).

Depending on the provisions of the trust, consider funding the marital trust (or, if applicable, the nonexempt marital trust) with a life estate in a particular property and funding the nonmarital or the exempt marital trust with a remainder interest in the same property. Likewise, subtrust allocation creates an opportunity for split-interest estate freezing. This transaction is also unlikely to run afoul of IRC §2702, because the surviving spouse does not transfer or retain property within the meaning of that section.

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§14.80 H. Select Allocation (Distribution) Date

After the asset allocation plan has been established, a date must be selected on which allocations and distributions to subtrusts will be made and the administrative trust will be considered terminated. The date chosen should be close in time to the date of actual distribution, *e.g.*, the last day of the preceding calendar month. However, if the trustee receives notice or actual knowledge, within 4 months after the date of issuance of the certificate of the death of the first spouse or entry of a judgment determining the fact of the first spouse's death (whichever event occurs first), that the decedent's genetic material is available for purposes of posthumous conception, and has not received written notice that the person designated by the decedent to use the material (usually the surviving spouse or registered domestic partner) does not intend to use the material for the posthumous conception of a child of the decedent, the trustee may not make a distribution of property until 2 years after the date of issuance of the certificate of the decedent's death or entry of a judgment determining the fact of decedent's death (whichever event occurs first)—unless the birth of a child conceived after death will not affect the proposed distribution. Fam C §7611(f); Prob C §§249.5-249.8, 6453(c). As a practical matter, notice of intent not to use the genetic material for posthumous conception may be omitted if the surviving spouse or registered domestic partner is the designated person and the trustee. Note that a posthumously conceived child may be an heir for intestate succession purposes and so entitled to a share of the trust estate as an omitted child only if the decedent consented in writing to use of the decedent's genetic material for posthumous conception purposes. See *Vernoff v Astrue* (9th Cir 2009) 568 F3d 1102 (posthumously conceived child was not entitled to Social Security survivor benefits, as allowed under less restrictive Arizona law in *Gillet-Barning v Barnhart* (9th Cir 2004) 371 F3d 593, because deceased father did not knowingly donate his sperm and did not consent to its use).

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§14.81 I. Select Asset Allocation Method: Segregated Trusts or Bookkeeping Entries

Some practitioners allocate assets among the successor subtrusts through bookkeeping entries rather than actual transfers. The author believes, however, that this method may be inconsistent with the trustee's duty to segregate trust assets. It may cloud issues of, *e.g.,* title and property taxes. Because each trust has its own employer identification number (TIN), and the trustee will notify each, *e.g.,* financial institution and brokerage house of the number under which to report income, the institutions may require segregation of assets. The practice of using bookkeeping entries seems particularly dangerous with respect to GST exemption allocations, which are required to be applied to separate trusts.

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§14.81A J. Pay Unpaid Expenses From Credit Trust or Marital Trust

The amount allocated to the credit trust may reflect unpaid administration expenses properly allocable to the decedent's share and deducted on IRS Form 706. The estate tax administration expense deduction has the effect of increasing the credit share because it reduces the marital deduction needed to reduce the estate tax to zero, as provided by the marital deduction formula clause. See §14.37. Accordingly, unpaid expenses deducted on Form 706 must be paid from the credit trust, assuming the expenses were taken into account in the credit share target calculation.

Conversely, administration expenses deducted on IRS Form 1041 generally do not increase the credit share. Under the IRS regulations, expenses deducted on Form 1041, other than estate management expenses relating to marital trust assets (estate transmission expenses), must be paid from the credit share or from trust income, not from the marital share. See §14.38. Thus, unpaid estate transmission expenses could be paid from the marital trust only if some or all of the trust income is allocated to the marital share, as could occur if a pecuniary credit/residuary marital formula or a fractional share formula is used. In all other cases, unpaid estate transmission expenses must be paid from the credit trust. Similarly, unpaid estate management expenses relating to credit trust assets must be paid from the credit trust.

In the hypothetical, $10,000 of expenses were deducted on Form 706, $10,000 of expenses were deducted on Form 1041, and $10,000 of expenses remain unpaid. See §14.15. Although the nature of the unpaid expenses is unspecified, the hypothetical trust uses a pecuniary marital/residuary credit formula, and there is nothing to suggest that the unpaid expenses are estate management expenses relating marital trust assets. Therefore, the $10,000 in unpaid expenses in the hypothetical should be paid from the credit trust.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.81B K. File Change-in-Ownership Statement for Real Property Allocated to Subtrust

§14.81B K. File Change-in-Ownership Statement for Real Property Allocated to Subtrust

Generally, the death of the property owner results in a change in ownership on the date of death. Rev & T C §61; 18 Cal Code Regs §462.260(c). For property tax purposes, trust beneficiaries are treated as the owners of real property held in trust. Thus, the deceased spouse's one-half community property interest or separate property interest in real property held in the family trust will be subject to reassessment unless an exclusion from change in ownership applies. In most cases, however, real property allocated to the marital trust or the credit trust will be eligible for an exclusion from change-in-ownership reassessment for property tax purposes. Among the available exclusions are the interspousal transfer exclusion (Cal Const art XIIIA, §2(g); Rev & T C §63) and the parent-child or grandparent-grandchild exclusion, discussed in §13.53. Usually the interspousal transfer exclusion will apply because the surviving spouse is generally considered the owner of both the marital trust and the credit trust as the sole current beneficiary during the survivor's lifetime, but this may not always be the case, depending on the terms of the trust. In any event, the trustee should file a change-in-ownership statement claiming the applicable exclusion. See §13.63. The applicable exclusion is also stated on the grant deed transferring the decedent's interest to the trust. See §14.109.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.82 V. PREPARE ASSET ALLOCATION AGREEMENT AND DIAGRAM

§14.82 V. PREPARE ASSET ALLOCATION AGREEMENT AND DIAGRAM

Once the allocation plan has been established, the attorney should prepare an allocation agreement setting forth the allocation between the various subtrusts, with attached schedules. See §14.84.

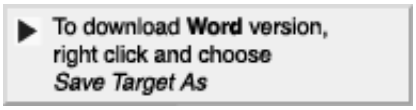
NOTE: After funding various subtrusts, it may be necessary to adjust the assets in these subtrusts because of taxes paid by the administrative trust. If a pecuniary amount is funded with assets that have increased in value since the deceased spouse's death, a capital gain will result. This gain will be recognized at the administrative trust level, and any tax payable at this level will reduce the amount that could be allocated between the credit and marital shares. If a pecuniary marital share/residuary credit share formula is used, tax payments will reduce the credit share. If, however, there is a pecuniary credit share/residuary marital share, the marital share will be reduced. If the latter applies, there may well be an immediate estate tax because the amount used to pay such taxes did not qualify for the marital deduction. It may be possible to argue by analogy, based on Rev Rul 93-48, 1993-2 Cum Bull 270, that postdeath payment of income taxes should not reduce the marital deduction.

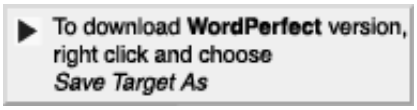
In addition to the allocation agreement, the attorney should consider preparing a diagram showing the allocations to the various subtrusts. See Exhibit T in §14.104 for an example of such a diagram.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.83 VI. CHECKLIST FOR IMPLEMENTING SUBTRUST ALLOCATION AND COMPLETION OF ADMINISTRATION

§14.83 VI. CHECKLIST FOR IMPLEMENTING SUBTRUST ALLOCATION AND COMPLETION OF ADMINISTRATION





- Obtain Employer Identification Numbers (TINs) for ongoing irrevocable trusts

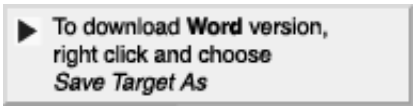
PRACTICE TIP: Blocks of TINs (for fiduciaries or persons representing estates or trusts only, not corporations or other entities) may be obtained from the Internal Revenue Service. Each month you receive ten numbers. You assign all or part of the numbers and fax the assigned numbers to the Internal Revenue Service. On receipt, they will fax you additional numbers. See §13.46 for complete details.

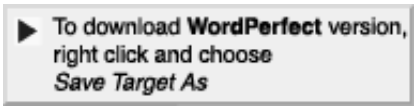
- Prepare certificates of trust for ongoing trusts.
- Prepare diagram of distribution.
- Send drafts of spreadsheet, asset schedules, and diagram to client and CPA.
- Consider having beneficiaries review distribution plan.
- Consider court approval of distribution plan.
- Obtain trustee's and CPA's approval of distribution plan if they are not present at meeting (see §14.57).
- Send written instructions to trustee regarding title to bank accounts.
- Prepare transfer documents for funding distributions.
- Deeds
- Assumption of mortgages
- Assignments of leases
- Assignments of notes and deeds of trust
- Prepare and file UCC-2 Statements
- Cancel old and issue new stock certificates for closely held corporations
- Assignments of partnership interests
- Assignments of unsecured promissory notes
- Letters to makers of notes advising of assignment
- Assignments of assets of sole proprietorship
- Assignments of personal property
- Forms to complete transfer of mobilehomes
- Stock powers, affidavit of domicile, and letter of instructions for stock transfers
- Letters to transfer agents, or deliver certificates to broker for transfer
- Letters of instructions to broker to transfer securities accounts
- Letters of instructions to mutual fund companies for transfer of accounts
- Transfer forms for treasury notes and bonds
- Letter and forms for transferring U.S. Savings Bonds
- Complete transfers of vehicles (cars, boats, airplanes)

- Miscellaneous assignments for other assets
- Prepare waivers of accounting if formal account required but not given.
- Prepare beneficiary receipts for outright distributions. Be sure no waiver of trustee's liability for distribution is included.
- Mail accounting, distribution checks/documents, and receipts by certified mail, if necessary.
- Prepare letter of instructions to client regarding administration of ongoing trusts.
- Prepare letter to CPA regarding ongoing trusts and allocation of responsibility for tax and accounting work.
- Send closing packet and termination of engagement letter to client with client survey.
- Remind surviving spouse about funding survivor's trust.
- Recommend and follow through on changes to surviving spouse's estate plan.
- Consider updating selection of fiduciaries.
- Consider updating powers of attorney.
- Consider amendment to survivor's trust.
- Remind surviving spouse regarding annual exclusion gifts.
- Consider gifting in excess of annual exclusion.
- Consider QPRT, GRAT, or other Irrevocable Trusts.
- Consider family limited partnership or limited liability company with children/irrevocable trusts.
- Consider steps to assure discounting of assets in marital trust.
- Consider unitrust conversion of marital trust.
- Consider codicil or new will to exercise powers of appointment.
- Consider need for life insurance and make referral.
- Consider need for long-term care insurance and make referral.
- Consider need for investment advice and make referral.

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§14.84 VII. FORM: SAMPLE TRUST ASSET ALLOCATION AGREEMENT AND ACCOMPANYING SCHEDULES





(Survivor's/Credit/Marital)

This Agreement is made as of March 1, 2010, by WENDY M. RICH as Trustee of the RICH FAMILY TRUST established under Declaration of Trust dated June 15, 1999 ("the Family Trust"), and as Trustee of the Survivor's Trust, Nonexempt Marital Trust, Exempt Marital Trust, and Credit Trust established thereunder. WENDY M. RICH shall be referred to in this Agreement as "the Trustee" or "the Survivor," as the context requires.

1. *Division of Family Trust Estate into Shares.* HANK T. RICH ("Decedent"), died on January 1, 2009. The Trust provides that, on Decedent's death, the Trustee shall divide the Trust Estate of the Family Trust into three separate shares: a Survivor's Share, a Marital Share, and a Credit Share.

a. *Survivor's Share.* The Survivor's Share shall consist of (i) the Survivor's interest in the community estate, if any, in the Trust; (ii) the Survivor's separate property, if any, in the Trust; and (iii) if the Survivor survives the Decedent for thirty (30) days, the Decedent's interest in any Tangible Property of a Personal or Household Nature (as defined in Article Six of the Trust) in the Trust or transferred to the Trust by reason of the Decedent's death.

b. *Marital Share.* The Marital Share shall consist of the minimum dollar amount (if any) of the Decedent's interest in the Trust Estate necessary as a marital deduction to eliminate (or reduce to the extent possible) any federal estate tax by reason of the Decedent's death, taking into account all factors relevant to this estate tax objective. In determining this dollar amount, final federal estate tax values are to be used. All assets used to fund the Marital Share are to be valued as of the date or dates of distribution.

c. *Credit Share.* The Credit Share shall consist of the balance of the Trust Estate (*i.e.*, the balance of the Trust Estate not otherwise apportioned to the Survivor's Share and the Marital Share).

2. *Survival Requirements*. The Survivor has survived the Decedent for more than 30 days, and allocation of the Trust Estate shall be made as set forth above.

3. *Allocation of Expenses of Administration to Credit Share*. To date, the Trustee has incurred $60,000 of administration expenses, of which $50,000 have been paid, all of which have been allocated to the Credit Share. All unpaid or contingent administration expenses or liabilities shall be charged exclusively to, and are hereby assumed by, the Credit Trust. The Trustee of the Credit Trust hereby agrees to reimburse the Family Trust and/or any other trust established under the Family Trust, as the case may be, for any expenses of administration paid by such trust or trusts that are properly chargeable to the Credit Trust. The Trustee of the Family Trust may (but shall not be required to) retain a reserve as part of the Family Trust for payment of unpaid or contingent expenses and liabilities as provided in paragraph 9 below.

4. *Funding of Trusts at Date-of-Distribution Values*. All assets allocated to the various trusts established under the terms of the Family Trust have been valued for purposes of such allocation at the date-of-distribution values.

5. *Calculation of Trust Estate Available for Distribution.* The total date-of-distribution value of the community property in the Trust Estate is $9,690,000. The Survivor's interest in the Trust Estate at date of distribution is $5,401,250. The Decedent's interest in the Trust Estate at date of distribution is $4,538,750. Of said amount, $1,191,237 constitutes the Marital Share, leaving the distribution value of the Credit Share at $3,347,512.

6. *Allocation of GST Exemption.* The trust instrument provides that Decedent's unused generation-skipping transfer (GST) exemption available at the date of Decedent's death be allocated first to the Credit Trust (including subtrusts thereunder), and then to the Marital Trust. If there is insufficient GST exemption so that the entire Marital Trust has a zero inclusion ratio, then the Trustee is directed to divide the Marital Trust into two separate trusts, a Nonexempt Marital Trust and an Exempt Marital Trust. Decedent's unused GST exemption at the date of Decedent's death was $3,500,000. The Trustee has allocated Decedent's GST exemption by a formula, the result of which, based on the values as reported on the Decedent's federal estate tax return, is that a total of $3,246,263 of GST exemption is allocated to the Credit Trust, being the date-of-death value of assets allocated to the Credit Trust. Based on such allocations, the Credit Trust will have an inclusion ratio of zero. The decedent's remaining GST exemption of $253,737 is allocated to the Exempt Marital Trust, for which a reverse QTIP election has been made.

7. *Allocation of the Assets of the Family Trust Estate.* The Trustee hereby allocates the following items of property to the various trusts established under the Family Trust:

a. To WENDY M. RICH, as Trustee of THE WENDY M. RICH SURVIVOR'S TRUST, the property described in Schedule A attached to this Agreement and incorporated by reference, having a total value of $5,401,250 on the date of distribution.

b. To WENDY M. RICH, as Trustee of THE HANK T. RICH CREDIT TRUST, the property described in Schedule B attached to this Agreement and incorporated by reference, having a total value of $3,347,512 on the date of distribution.

c. To WENDY M. RICH, as Trustee of THE HANK T. RICH EXEMPT MARITAL TRUST, the property described in Schedule C attached to this Agreement and incorporated by reference, having a total value of $253,737 on the date of distribution.

d. To WENDY M. RICH, as Trustee of THE HANK T. RICH NONEXEMPT MARITAL TRUST, the property described in Schedule D attached to this Agreement and incorporated by reference, having a total value of $937,500 on the date of distribution.

8. *Interest on Pecuniary Gifts*. Under California law, a pecuniary gift bears interest if it is paid after one (1) year from the date of death of the Decedent unless such interest is waived. Because distribution of the pecuniary formula marital deduction share was made more than one year after Decedent's death, interest was required to be paid in satisfying said pecuniary formula share as follows: $13,737 allocated to the Exempt Marital Trust.

9. *Reserve for Contingent Liabilities.* Notwithstanding the provisions of paragraph 7 above, the Trustee may (but shall not be required to) retain as part of the Trust Estate of the Family Trust a reasonable reserve for unpaid and contingent administration expenses and liabilities chargeable to the Credit Trust hereunder for such period of time and in such amount as the Trustee, in the Trustee's sole discretion, determines. The balance of such reserve remaining after payment of all such charges shall be distributed to the Credit Trust.

10. *Further Documents.* The Trustee agrees to make, execute, and acknowledge such deeds, assignments, bills of sale, stock powers, letters of instruction, and other documents of transfer or conveyance as reasonably required to carry out the distributions set forth in paragraph 7 above and otherwise to carry out the terms of this Agreement.

11. *Adjustments to Shares on Audit.* The Trustee has determined the pecuniary marital formula gift using the values reported on the Decedent's federal estate tax return. The Trustee has also allocated the Decedent's GST exemption and has divided the Marital Trust into two separate trusts based on said values. The Trustee recognizes that the values reported on the federal estate tax return are tentative and that it may take months or years before the values or the estate assets are finally determined for federal estate tax purposes. Nevertheless, for the purpose of efficient trust administration, the Trustee desires to allocate and distribute the Trust Estate of the Family Trust, subject to whatever adjustments may be required by reason of any adjustments made with respect to the asset values or the amount of deductions, including the marital deduction, as reported on Decedent's federal estate tax return. If any such adjustments lead to a conclusion that any trust referred to herein has been overfunded or underfunded, the Trustee agrees to make whatever transfers or cash payments as may be necessary between or among the various trusts in order to give effect to the Decedent's directions in the Declaration of Trust concerning qualification for the marital deduction and

for optimal allocation of the Decedent's GST exemption. The amount of any overfunding shall bear interest at a rate per annum equal to the short-term applicable federal rate (compounded annually) in effect under Internal Revenue Code §1274(d), from the date of distribution to the date of payment, such rate to be recalculated thereafter on each anniversary date of the date of distribution. Unpaid interest shall be accumulated and added to principal as of each such anniversary date. The entire unpaid principal balance of such overfunding, together with all current and accumulated interest, shall be due and payable on demand by any underfunded trust, and it may be prepaid, in whole or in part, at any time without premium or penalty. Unless otherwise agreed by the parties, all payments shall be applied first to current interest, then to accumulated interest, and finally to the remaining principal.

12. *Indemnification*. The Trustee of each separate trust represented hereby agrees to indemnify, defend, and hold each and every other Trustee free and harmless from and against any and all liability, damages, losses, or expenses, including reasonable attorneys' and accountants' fees howsoever arising by reason of the distribution of the Trust Estate under this Agreement, including payment of taxes, interest, and penalties, if any.

13. *Binding on Successors.* This Agreement shall be binding on the heirs, successors, and assigns of the parties hereto, including any successor trustees of any of the trusts referred to herein.

14. *Governing Law.* This Agreement shall be governed by and construed in accordance with the laws of the State of California.

Executed at Napa, California, on April 20, 2010.

WENDY M. RICH, as Trustee of the Family Trust, Credit Trust, Exempt Marital Trust, Non-Exempt Marital Trust, and Survivor's Trust

SCHEDULE A
Assets Allocated to Survivor's Trust

Description	Net Value on Date of Death	Net Value on Date of Allocation
Personal residence	500,000.00	500,000.00
Lake Tahoe vacation home	250,000.00	250,000.00
Commercial Property interest (51.1%)	2,086,963.00	4,086,963.00
Franklin tax-exempt fund	33,500.00	40,000.00
Georgia Pacific stock	17,500.00	28,500.00
Merck stock	29,750.00	39,000.00
Home Depot stock	20,500.00	40,500.00
National RV stock	85,000.00	80,000.00
Mobil Oil stock	90,000.00	147,000.00
Mutual fund	0.00	25,000.00
Secured note	75,000.00	75,000.00
Unsecured note	15,000.00	15,000.00
Household effects	25,000.00	25,000.00
Classic car	20,000.00	20,000.00
Savings account (portion of)	@ 18,692.00	29,287.00
TOTAL	5,226,905.00	5,401,250.00

SCHEDULE B

Assets Allocated to Credit Trust

Description	Net Value on Date of Death	Net Value on Date of Allocation
Hawaii Condo (50%)	75,000.00	75,000.00
Commercial Property Interest (35.1%)	2,807,512.00	2,807,512.00
Fleetwood stock	223,750.00	250,000.00
IBM stock	90,000.00	140,000.00
ITT stock	50,000.00	75,000.00
TOTAL	3,246,262.00	3,347,512.00

SCHEDULE C
Assets Allocated to Exempt Marital Trust

Description	Net Value on Date of Death	Net Value on Date of Allocation
Commercial Property Interest (3.2%)	253,737.00	253,737.00
TOTAL	253,737.00	253,737.00

SCHEDULE D
Assets Allocated to Nonexempt Marital Trust

Description	Net Value on Date of Death	Net Value on Date of Allocation
Hawaii Condo (50%)	75,000.00	75,000.00
Commercial Property Interest (10.6%)	851,787.00	851,787.00
Savings account (portion of)	@6,308.00	10,713.00
TOTAL	933,095.00	937,500.00

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/ VIII. EXHIBITS/§14.85 A. Form: Spreadsheet Listing Trust and Nontrust Assets With Separate Columns Based on Character of Assets

VIII. EXHIBITS

§14.85 A. Form: Spreadsheet Listing Trust and Nontrust Assets With Separate Columns Based on Character of Assets

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST						
2	FIRST DEATH (January 1, 2009)						
3	TRUE WORTH PECUNIARY MARITAL						
4		(1)	(2)	(3)	(4)	(5)	(6)
5							
6			DOD				
7	Schedule of Assets		Title and Values				
8		Trust/CP	Trust/HSP	Trust/WSP	Non Trust	Joint Tenancy	CP w RoS
9	A. Real Estate						
10	1. Personal residence						
11	2. Hawaii condo						
12	3. Lake Tahoe Vacation Home						
13	4. 80% Commercial Property						
14							
15	B. Securities						
16	1. Franklin Tax Exempt Fund						
17	2. Georgia Pac, 225 sh						
18	3. Merck, 275 shares						
19	4. Home Depot, 400 shares						
20	5. Fleetwood stock, 2016 sh						
21	6. National R.V., 2045 shares						
22	7. IBM, 1730 shares						
23	8. ITT, 877 shares						
24	9. Mobil Oil, 388 shares						
25	10. U.S. Savings Bond						
26	11. Mutual Fund						
27							
28	C. Bank Accounts						
29	1. Checking acct.						
30	2. Savings acct						
31							
32	D. Promissory Notes						
33	1. Secured note						
34	2. Unsecured note						
35							
36	E. Business Interests						
37							
38	F. Life Insurance						
39	1. Policy on Hank						
40	2. Policy on Hank (Wendy is bene)						
41							
42	G. Annuities & Retirement						
43	1. Hank's retirement plan						
44	2. Wendy's IRA						
45							
46	H. Miscellaneous Property						
47	1. Household effects						
48	2. Dodge Ram Dually						
49	3. Classic car						
50	4. Sea Ray ski boat						
51							
52	TOTALS:	0	0	0	0	0	0

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.86 B. Form: Spreadsheet Listing Trust and Nontrust Assets With Separate Columns for Title and Date-of-Death Values

§14.86 B. Form: Spreadsheet Listing Trust and Nontrust Assets With Separate Columns for Title and Date-of-Death Values

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST		
2	FIRST DEATH (January 1, 2009)		
3	TRUE WORTH PECUNIARY MARITAL		
4		(1)	(2)
5			
6		DOD	DOD
7	Schedule of Assets	Title	Value
8			
9	A. Real Estate		
10	1. Personal residence	Trust/CP	500,000
11	2. Hawaii condo	Trust/CP	150,000
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000
13	4. 80% Commercial Property	Trust/CP	4,000,000
14			
15	B. Securities		
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500
17	2. Georgia Pac, 225 sh	Trust/CP	17,500
18	3. Merck, 275 shares	Trust/CP	29,750
19	4. Home Depot, 400 shares	Trust/CP	20,500
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750
21	6. National R.V., 2045 shares	Trust/CP	85,000
22	7. IBM, 1730 shares	Trust/CP	90,000
23	8. ITT, 877 shares	Trust/CP	50,000
24	9. Mobil Oil, 388 shares	Trust/CP	90,000
25	10. U.S. Savings Bond	Trust/CP	50,000
26	11. Mutual Fund		
27			
28	C. Bank Accounts		
29	1. Checking acct.	JT	15,000
30	2. Savings acct	Trust/CP	25,000
31			
32	D. Promissory Notes		
33	1. Secured note	Trust/CP	75,000
34	2. Unsecured note	Trust/CP	15,000
35			
36	E. Business Interests		
37			
38	F. Life Insurance		
39	1. Policy on Hank	Irrev/Tr	N/A
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000
41			
42	G. Annuities & Retirement		
43	1. Hank's retirement plan	Non-Trust	135,000
44	2. Wendy's IRA	Non-Trust	50,000
45			
46	H. Miscellaneous Property		
47	1. Household effects	Trust/CP	25,000
48	2. Dodge Ram Dually	JT	35,000
49	3. Classic car	Trust/CP	20,000
50	4. Sea Ray ski boat	JT	15,000
51			
52	TOTALS:		6,025,000
53		CP Trust	
54		HSP Trust	
55		WSP Trust	
56		JT	
57		Non-Trust	
58		Total	

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.87 C. Form: Augmented Spreadsheet (Exhibit B) Showing Debts for Each Asset

§14.87 C. Form: Augmented Spreadsheet (Exhibit B) Showing Debts for Each Asset

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST			
2	FIRST DEATH (January 1, 2006)			
3	TRUE WORTH PECUNIARY MARITAL			
4		(1)	(2)	(3)
5				
6		DOD	DOD	Less
7	Schedule of Assets	Title	Value	Debt
8				
9	A. Real Estate			
10	1. Personal residence	Trust/CP	500,000	0
11	2. Hawaii condo	Trust/CP	150,000	0
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0
13	4. 80% Commercial Property	Trust/CP	4,000,000	0
14				
15	B. Securities			
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0
18	3. Merck, 275 shares	Trust/CP	29,750	0
19	4. Home Depot, 400 shares	Trust/CP	20,500	0
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0
21	6. National R.V., 2045 shares	Trust/CP	85,000	0
22	7. IBM, 1730 shares	Trust/CP	90,000	0
23	8. ITT, 877 shares	Trust/CP	50,000	0
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0
25	10. U.S. Savings Bond	Trust/CP	50,000	0
26	11. Mutual Fund			
27				
28	C. Bank Accounts			
29	1. Checking acct.	JT	15,000	0
30	2. Savings acct	Trust/CP	25,000	0
31				
32	D. Promissory Notes			
33	1. Secured note	Trust/CP	75,000	0
34	2. Unsecured note	Trust/CP	15,000	0
35				
36	E. Business Interests			
37				
38	F. Life Insurance			
39	1. Policy on Hank	Irrev/Tr	N/A	
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0
41				
42	G. Annuities & Retirement			
43	1. Hank's retirement plan	Non-Trust	135,000	0
44	2. Wendy's IRA	Non-Trust	50,000	0
45				
46	H. Miscellaneous Property			
47	1. Household effects	Trust/CP	25,000	0
48	2. Dodge Ram Dually	JT	35,000	0
49	3. Classic car	Trust/CP	20,000	0
50	5. Sea Ray ski boat	JT	15,000	0
51				
52	TOTALS:		6,025,000	0
53				
54			DODeath	DODist
55		CP Trust	5,500,000	0
56		HSP Trust	0	0
57		WSP Trust	250,000	0
58		JT	65,000	0
59		Non-Trust	210,000	0
60		Total	6,025,000	0

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.88 D. Form: Augmented Spreadsheet (Exhibit C) Showing Net Value

§14.88 D. Form: Augmented Spreadsheet (Exhibit C) Showing Net Value

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST				
2	FIRST DEATH (January 1, 2009)				
3	TRUE WORTH PECUNIARY MARITAL				
4		(1)	(2)	(3)	(4)
5					
6		DOD	DOD	Less	Net
7	Schedule of Assets	Title	Value	Debt	Value
8					
9	A. Real Estate				
10	1. Personal residence	Trust/CP	500,000	0	500,000
11	2. Hawaii condo	Trust/CP	150,000	0	150,000
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000
13	4. 80% Commercial Property	Trust/CP	4,000,000	0	4,000,000
14					
15	B. Securities				
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000
26	11. Mutual Fund				
27					
28	C. Bank Accounts				
29	1. Checking acct.	JT	15,000	0	15,000
30	2. Savings acct	Trust/CP	25,000	0	25,000
31					
32	D. Promissory Notes				
33	1. Secured note	Trust/CP	75,000	0	75,000
34	2. Unsecured note	Trust/CP	15,000	0	15,000
35					
36	E. Business Interests				
37					
38	F. Life Insurance				
39	1. Policy on Hank	Irrev/Tr	N/A		
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0	25,000
41					
42	G. Annuities & Retirement				
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000
45					
46	H. Miscellaneous Property				
47	1. Household effects	Trust/CP	25,000	0	25,000
48	2. Dodge Ram Dually	JT	35,000	0	35,000
49	3. Classic car	Trust/CP	20,000	0	20,000
50	4. Sea Ray ski boat	JT	15,000	0	15,000
51					
52	TOTALS:		6,025,000	0	6,025,000
53					
54			DODeath	DODist	
55		CP Trust	5,500,000	0	
56		HSP Trust	0	0	
57		WSP Trust	250,000	0	
58		JT	65,000	0	
59		Non-Trust	210,000	0	
60		Total	6,025,000	0	

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.89 E. Form: Augmented Spreadsheet (Exhibit D) Showing Allocation Dates

§14.89 E. Form: Augmented Spreadsheet (Exhibit D) Showing Allocation Dates

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST					
2	FIRST DEATH (January 1, 2009)					
3	TRUE WORTH PECUNIARY MARITAL					
4		(1)	(2)	(3)	(4)	(5)
5						
6		DOD	DOD	Less	Net	Date of
7	Schedule of Assets	Title	Value	Debt	Value	Distrib
8						
9	A. Real Estate					
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10
13	4. 80% Commercial Property	Trust/CP	4,000,000	0	4,000,000	1-Mar-10
14						
15	B. Securities					
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-10
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10
26	11. Mutual Fund					
27						
28	C. Bank Accounts					
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10
31						
32	D. Promissory Notes					
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10
35						
36	E. Business Interests					
37						
38	F. Life Insurance					
39	1. Policy on Hank	Irrev/Tr	N/A			
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0	25,000	1-Jan-09
41						
42	G. Annuities & Retirement					
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09
45						
46	H. Miscellaneous Property					
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09
51						
52	TOTALS:		6,025,000	0	6,025,000	
53						
54			DODeath	DODist		
55		CP Trust	5,500,000	0		
56		HSP Trust	0	0		
57		WSP Trust	250,000	0		
58		JT	65,000	0		
59		Non-Trust	210,000	0		
60		Total	6,025,000	0		

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.90 F. Form: Augmented Spreadsheet (Exhibit E) Showing Allocation Values

§14.90 F. Form: Augmented Spreadsheet (Exhibit E) Showing Allocation Values

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST							
2	FIRST DEATH (January 1, 2009)							
3	TRUE WORTH PECUNIARY MARITAL							
4		(1)	(2)	(3)	(4)	(5)	(6)	(7)
5							Distribution	
6		DOD	DOD	Less	Net	Date of	Value	
7	Schedule of Assets	Title	Value	Debt	Value	Distribution	Trust	Non-Trust
8								
9	A. Real Estate							
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10	500,000	
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10	150,000	
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10	250,000	
13	4. 80% Commercial Property	Trust/CP	4,000,000	0	4,000,000	1-Mar-10	4,000,000	
14								
15	B. Securities							
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10	40,000	
17	2. Georgia Pac, 225 shares	Trust/CP	17,500	0	17,500	1-Mar-10	28,500	
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10	39,000	
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10	40,500	
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10	250,000	
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10	80,000	
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10	140,000	
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10	75,000	
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10	147,000	
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10	0	
26	11. Mutual Fund						25,000	
27								
28	C. Bank Accounts							
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09		5,000
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10	40,000	
31								
32	D. Promissory Notes							
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10	75,000	
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10	15,000	
35								
36	E. Business Interests							
37								
38	F. Life Insurance							
39	1. Policy on Hank	Irrev/Tr	N/A					
40	2. Policy on Hank	Non-Trust	25,000	0	25,000	1-Jan-09		0
41	(Wendy is beneficiary)							
42	G. Annuities & Retirement							
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09		135,000
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09		50,000
45								
46	H. Miscellaneous Property							
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10	25,000	
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09		35,000
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10	20,000	
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09		15,000
51								
52	TOTALS:		6,025,000	0	6,025,000		5,940,000	240,000
53								
54			DODeath	DODist				
55		CP Trust	5,500,000	5,690,000				
56		HSP Trust	0	0				
57		WSP Trust	250,000	250,000				
58		JT	65,000	55,000				
59		Non-Trust	210,000	185,000				
60		Total	6,025,000	6,180,000				
61								

Section 14.91, a two-page spreadsheet, begins on the next page.

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.91 G. Form: Augmented Spreadsheet (Exhibit F) Showing Net Change From Date of Death to Date of Allocation

§14.91 G. Form: Augmented Spreadsheet (Exhibit F) Showing Net Change From Date of Death to Date of Allocation

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST				
2	FIRST DEATH (January 1, 2009)				
3	TRUE WORTH PECUNIARY MARITAL				
4		(1)	(2)	(3)	(4)
5					
6		DOD	DOD	Less	Net
7	Schedule of Assets	Title	Value	Debt	Value
8					
9	A. Real Estate				
10	1. Personal residence	Trust/CP	500,000	0	500,000
11	2. Hawaii condo	Trust/CP	150,000	0	150,000
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000
14					
15	B. Securities				
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000
26	11. Mutual Fund				
27					
28	C. Bank Accounts				
29	1. Checking acct.	JT	15,000	0	15,000
30	2. Savings acct	Trust/CP	25,000	0	25,000
31					
32	D. Promissory Notes				
33	1. Secured note	Trust/CP	75,000	0	75,000
34	2. Unsecured note	Trust/CP	15,000	0	15,000
35					
36	E. Business Interests				
37					
38	F. Life Insurance				
39	1. Policy on Hank	Irrev/Tr	N/A		
40	2. Policy on Hank (Wendy is beneficiary	Non-Trust	25,000	0	25,000
41					
42	G. Annuities & Retirement				
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000
45					
46	H. Miscellaneous Property				
47	1. Household effects	Trust/CP	25,000	0	25,000
48	2. Dodge Ram Dually	JT	35,000	0	35,000
49	3. Classic car	Trust/CP	20,000	0	20,000
50	4. Sea Ray ski boat	JT	15,000	0	15,000
51					
52	TOTALS:		10,025,000	0	10,025,000
53					
54			DODeath	DODist	
55		CP Trust	9,500,000	9,690,000	
56		HSP Trust	0	0	
57		WSP Trust	250,000	250,000	
58		JT	65,000	55,000	
59		Non-Trust	210,000	185,000	
60		Total	10,025,000	10,180,000	

Print

	F	G	H	I	J
1					
2					
3					
4	(5)	(6)	(7)	(8)	
5		Distribution			
6	Date of	Value		Net Change	
7	Distrib	Trust	Non-Trust	Trust	Non-Trust
8					
9					
10	1-Mar-10	500,000		0	
11	1-Mar-10	150,000		0	
12	1-Mar-10	250,000		0	
13	1-Mar-10	8,000,000		0	
14					
15					
16	1-Mar-10	40,000		6,500	
17	1-Mar-10	28,500		11,000	
18	1-Mar-10	39,000		9,250	
19	1-Mar-10	40,500		20,000	
20	1-Mar-10	250,000		26,250	
21	1-Mar-10	80,000		-5,000	
22	1-Mar-10	140,000		50,000	
23	1-Mar-10	75,000		25,000	
24	1-Mar-10	147,000		57,000	
25	1-Mar-10	0		-50,000	* Not included below
26		25,000			
27					
28					
29	1-Jan-09		5,000		-10,000
30	1-Mar-10	40,000		15,000	* Not included below
31					
32					
33	1-Mar-10	75,000		0	
34	1-Mar-10	15,000		0	
35					
36					
37					
38					
39					
40	1-Jan-09		0		-25,000
41					
42					
43	1-Jan-09		135,000		0
44	1-Jan-09		50,000		0
45					
46					
47	1-Mar-10	25,000		0	
48	1-Jan-09		35,000		0
49	1-Mar-10	20,000		0	
50	1-Jan-09		15,000		0
51					
52		9,940,000	240,000	200,000	-35,000
53					
54					
55					
56				*Net change in bank acount and	
57				bonds are "Not included below"	
58				because these changes do not	
59				reflect gain or loss. The purpose	
60				of this column is to calculate net gain or loss.	

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.92 H. Form: Augmented Spreadsheet (Exhibit G) Showing Value of Assets Passing Outside Trust

§14.92 H. Form: Augmented Spreadsheet (Exhibit G) Showing Value of Assets Passing Outside Trust

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST				
2	FIRST DEATH (January 1, 2009)				
3	TRUE WORTH PECUNIARY MARITAL				
4		(1)	(2)	(3)	(4)
5					
6		DOD	DOD	Less	Net
7	Schedule of Assets	Title	Value	Debt	Value
8					
9	A. Real Estate				
10	1. Personal residence	Trust/CP	500,000	0	500,000
11	2. Hawaii condo	Trust/CP	150,000	0	150,000
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000
14					
15	B. Securities				
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000
26	11. Mutual Fund				
27					
28	C. Bank Accounts				
29	1. Checking acct.	JT	15,000	0	15,000
30	2. Savings acct	Trust/CP	25,000	0	25,000
31					
32	D. Promissory Notes				
33	1. Secured note	Trust/CP	75,000	0	75,000
34	2. Unsecured note	Trust/CP	15,000	0	15,000
35					
36	E. Business Interests				
37					
38	F. Life Insurance				
39	1. Policy on Hank	Irrev/Tr	N/A		
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0	25,000
41					
42	G. Annuities & Retirement				
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000
45					
46	H. Miscellaneous Property				
47	1. Household effects	Trust/CP	25,000	0	25,000
48	2. Dodge Ram Dually	JT	35,000	0	35,000
49	3. Classic car	Trust/CP	20,000	0	20,000
50	4. Sea Ray ski boat	JT	15,000	0	15,000
51					
52	TOTALS:		10,025,000	0	10,025,000
53					
54			DODeath	DODist	
55		CP Trust	9,500,000	9,690,000	
56		HSP Trust	0	0	
57		WSP Trust	250,000	250,000	
58		JT	65,000	55,000	
59		Non-Trust	210,000	185,000	
60		Total	10,025,000	10,180,000	
61					

Print

	F	G	H	I	J	K
1						
2						
3						
4	(5)	(6)	(7)	(8)		(9)
5		Distribution				
6	Date of	Value		Net Change		Wendy
7	Distribution	Trust	Non-Trust	Trust	Non-Trust	Outright
8						
9						
10	1-Mar-10	500,000		0		
11	1-Mar-10	150,000		0		
12	1-Mar-10	250,000		0		
13	1-Mar-10	8,000,000		0		
14						
15						
16	1-Mar-10	40,000		6,500		
17	1-Mar-10	28,500		11,000		
18	1-Mar-10	39,000		9,250		
19	1-Mar-10	40,500		20,000		
20	1-Mar-10	250,000		26,250		
21	1-Mar-10	80,000		-5,000		
22	1-Mar-10	140,000		50,000		
23	1-Mar-10	75,000		25,000		
24	1-Mar-10	147,000		57,000		
25	1-Mar-10	0		-50,000	* Not included below	
26		25,000				
27						
28						
29	1-Jan-09		5,000		-10,000	5,000
30	1-Mar-10	40,000		15,000	* Not included below	
31						
32						
33	1-Mar-10	75,000		0		
34	1-Mar-10	15,000		0		
35						
36						
37						
38						
39						
40	1-Jan-09		0		-25,000	
41						
42						
43	1-Jan-09		135,000		0	135,000
44	1-Jan-09		50,000		0	50,000
45						
46						
47	1-Mar-10	25,000		0		
48	1-Jan-09		35,000		0	35,000
49	1-Mar-10	20,000		0		
50	1-Jan-09		15,000		0	15,000
51						
52		9,940,000	240,000	200,000	-35,000	240,000
53						
54						
55				*Net change in bank acount and		
56				bonds are "Not included below"		
57				because these changes do not		
58				reflect gain or loss. The purpose		
59				of this column is to calculate net		
60				gain or loss.		
61						

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.93 I. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Disclaimer Trust Plan

§14.93 I. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Disclaimer Trust Plan

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST					
2	FIRST DEATH (January 1, 2009)					
3	TRUE WORTH PECUNIARY MARITAL					
4		(1)	(2)	(3)	(4)	(5)
5						
6		DOD	DOD	Less	Net	Date of
7	Schedule of Assets	Title	Value	Debt	Value	Distribution
8						
9	A. Real Estate					
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000	1-Mar-10
14						
15	B. Securities					
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-10
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10
26	11. Mutual Fund					
27						
28	C. Bank Accounts					
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10
31						
32	D. Promissory Notes					
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10
35						
36	E. Business Interests					
37						
38	F. Life Insurance					
39	1. Policy on Hank	Irrev/Tr	N/A			
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0	25,000	1-Jan-09
41						
42	G. Annuities & Retirement					
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09
45						
46	H. Miscellaneous Property					
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09
51						
52	TOTALS:		10,025,000	0	10,025,000	
53						
54			DODeath	DODist		
55		CP Trust	9,500,000	9,690,000		
56		HSP Trust	0	0		
57		WSP Trust	250,000	250,000		
58		JT	65,000	55,000		
59		Non-Trust	210,000	185,000		
60		Total	10,025,000	10,180,000		

Print

	G	H	I	J	K	L	M
1							
2							
3							
4	(6)	(7)		(8)	(9)	(10)	(11)
5						Surv.Share	Disc. Share
6	Distribution Value		Net Change		Wendy	Survivor's	Disclaimer
7	Trust	Non-Trust	Trust	Non-Trust	Outright	Trust	Trust
8							
9							
10	500,000		0				
11	150,000		0				
12	250,000		0				
13	8,000,000		0				
14							
15							
16	40,000		6,500				
17	28,500		11,000				
18	39,000		9,250				
19	40,500		20,000				
20	250,000		26,250				
21	80,000		-5,000				
22	140,000		50,000				
23	75,000		25,000				
24	147,000		57,000				
25	0		-50,000	* Not included below			
26	25,000						
27							
28							
29		5,000		-10,000	5,000		
30	40,000		15,000	* Not included below			
31							
32							
33	75,000		0				
34	15,000		0				
35							
36							
37							
38							
39							
40		0		-25,000			
41							
42							
43		135,000		0	135,000		
44		50,000		0	50,000		
45							
46							
47	25,000		0				
48		35,000		0	35,000		
49	20,000		0				
50		15,000		0	15,000		
51							
52	9,940,000	240,000	200,000	-35,000	240,000		
53							
54							
55			*Net change in bank acount and bonds are				
56			"Not included below" because these				
57			changes do not reflect gain or loss. The				
58			purpose of this column is to calculate				
59			net gain or loss.				
60							

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.94 J. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust Plan (Without Marital Share)

§14.94 J. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust Plan (Without Marital Share)

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST					
2	FIRST DEATH (January 1, 2009)					
3	TRUE WORTH PECUNIARY MARITAL					
4		(1)	(2)	(3)	(4)	(5)
5						
6		DOD	DOD	Less	Net	Date of
7	Schedule of Assets	Title	Value	Debt	Value	Distrib
8						
9	A. Real Estate					
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000	1-Mar-10
14						
15	B. Securities					
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-10
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10
26	11. Mutual Fund					
27						
28	C. Bank Accounts					
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10
31						
32	D. Promissory Notes					
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10
35						
36	E. Business Interests					
37						
38	F. Life Insurance					
39	1. Policy on Hank	Irrev/Tr	N/A			
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0	25,000	1-Jan-09
41						
42	G. Annuities & Retirement					
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09
45						
46	H. Miscellaneous Property					
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09
51						
52	TOTALS:		10,025,000	0	10,025,000	
53						
54			DODeath	DODist		
55		CP Trust	9,500,000	9,690,000		
56		HSP Trust	0	0		
57		WSP Trust	250,000	250,000		
58		JT	65,000	55,000		
59		Non-Trust	210,000	185,000		
60		Total	10,025,000	10,180,000		

Print

	G	H	I	J	K	L	M
1							
2							
3							
4	(6)	(7)		(8)	(9)	(10)	(11)
5						Surv.Share	Credit Share
6	Distribution Value		Net Change		Wendy	Survivor's	Credit
7	Trust	Non-Trust	Trust	Non-Trust	Outright	Trust	Trust
8							
9							
10	500,000		0				
11	150,000		0				
12	250,000		0				
13	8,000,000		0				
14							
15							
16	40,000		6,500				
17	28,500		11,000				
18	39,000		9,250				
19	40,500		20,000				
20	250,000		26,250				
21	80,000		-5,000				
22	140,000		50,000				
23	75,000		25,000				
24	147,000		57,000				
25	0		-50,000	* Not included below			
26	25,000						
27							
28							
29		5,000		-10,000	5,000		
30	40,000		15,000	* Not included below			
31							
32							
33	75,000		0				
34	15,000		0				
35							
36							
37							
38							
39							
40		0		-25,000			
41							
42							
43		135,000		0	135,000		
44		50,000		0	50,000		
45							
46							
47	25,000		0				
48		35,000		0	35,000		
49	20,000		0				
50		15,000		0	15,000		
51							
52	9,940,000	240,000	200,000	-35,000	240,000	0	0
53							
54							
55			*Net change in bank acount and bonds are				
56			"Not included below" because these				
57			changes do not reflect gain or loss. The				
58			purpose of this column is to calculate				
59			net gain or loss.				
60							

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.95 K. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust Plan (With Marital Share)

§14.95 K. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust Plan (With Marital Share)

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST					
2	FIRST DEATH (January 1, 2009)					
3	TRUE WORTH PECUNIARY MARITAL					
4		(1)	(2)	(3)	(4)	(5)
5						
6		DOD	DOD	Less	Net	Date of
7	Schedule of Assets	Title	Value	Debt	Value	Distrib
8						
9	A. Real Estate					
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000	1-Mar-10
14						
15	B. Securities					
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-10
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10
26	11. Mutual Fund					
27						
28	C. Bank Accounts					
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10
31						
32	D. Promissory Notes					
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10
35						
36	E. Business Interests					
37						
38	F. Life Insurance					
39	1. Policy on Hank	Irrev/Tr	N/A			
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0	25,000	1-Jan-09
41						
42	G. Annuities & Retirement					
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09
45						
46	H. Miscellaneous Property					
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09
51						
52	TOTALS:		10,025,000	0	10,025,000	
53						
54			DODeath	DODist		
55		CP Trust	9,500,000	9,690,000		
56		HSP Trust	0	0		
57		WSP Trust	250,000	250,000		
58		JT	65,000	55,000		
59		Non-Trust	210,000	185,000		
60		Total	10,025,000	10,180,000		

Print

	G	H	I	J	K	L	M	N
1								
2								
3								
4	(6)	(7)		(8)	(9)	(10)	(11)	(12)
5						Surv.Share	Marital Share	Credit Share
6	Distribution Value			Net Change	Wendy	Survivor's		Credit
7	Trust	Non-Trust	Trust	Non-Trust	Outright	Trust		Trust
8								
9								
10	500,000		0					
11	150,000		0					
12	250,000		0					
13	8,000,000		0					
14								
15								
16	40,000		6,500					
17	28,500		11,000					
18	39,000		9,250					
19	40,500		20,000					
20	250,000		26,250					
21	80,000		-5,000					
22	140,000		50,000					
23	75,000		25,000					
24	147,000		57,000					
25	0		-50,000	* Not included below				
26	25,000							
27								
28								
29		5,000		-10,000	5,000			
30	40,000		15,000	* Not included below				
31								
32								
33	75,000		0					
34	15,000		0					
35								
36								
37								
38								
39								
40		0		-25,000				
41								
42								
43		135,000		0	135,000			
44		50,000		0	50,000			
45								
46								
47	25,000		0					
48		35,000		0	35,000			
49	20,000		0					
50		15,000		0	15,000			
51								
52	9,940,000	240,000	200,000	-35,000	240,000	0	0	0
53								
54								
55			*Net change in bank acount and bonds are					
56			"Not included below" because these					
57			changes do not reflect gain or loss. The					
58			purpose of this column is to calculate					
59			net gain or loss.					
60								

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.96 L. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust/Marital Trust (Without GST Division) Plan

§14.96 L. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust/Marital Trust (Without GST Division) Plan

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST					
2	FIRST DEATH (January 1, 2009)					
3	TRUE WORTH PECUNIARY MARITAL					
4		(1)	(2)	(3)	(4)	(5)
5						
6		DOD	DOD	Less	Net	Date of
7	Schedule of Assets	Title	Value	Debt	Value	Distribution
8						
9	A. Real Estate					
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000	1-Mar-10
14						
15	B. Securities					
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-10
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10
26	11. Mutual Fund					
27						
28	C. Bank Accounts					
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10
31						
32	D. Promissory Notes					
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10
35						
36	E. Business Interests					
37						
38	F. Life Insurance					
39	1. Policy on Hank	Irrev/Tr	N/A			
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0	25,000	1-Jan-09
41						
42	G. Annuities & Retirement					
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09
45						
46	H. Miscellaneous Property					
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09
51						
52	TOTALS:		10,025,000	0	10,025,000	
53						
54			DODeath	DODist		
55		CP Trust	9,500,000	9,690,000		
56		HSP Trust	0	0		
57		WSP Trust	250,000	250,000		
58		JT	65,000	55,000		
59		Non-Trust	210,000	185,000		
60		Total	10,025,000	10,180,000		

Print

	G	H	I	J	K	L	M	N
1								
2								
3								
4	(6)	(7)	(8)		(9)	(10)	(11)	(12)
5						Surv.Share	Marital Share	Credit Share
6	Distribution Value		Net Change		Wendy	Survivor's	Martial	Credit
7	Trust	Non-Trust	Trust	Non-Trust	Outright	Trust	Trust	Trust
8								
9								
10	500,000		0					
11	150,000		0					
12	250,000		0					
13	8,000,000		0					
14								
15								
16	40,000		6,500					
17	28,500		11,000					
18	39,000		9,250					
19	40,500		20,000					
20	250,000		26,250					
21	80,000		-5,000					
22	140,000		50,000					
23	75,000		25,000					
24	147,000		57,000					
25	0		-60,000	* Not included below				
26	25,000							
27								
28								
29		5,000		-10,000	5,000			
30	40,000		15,000	* Not included below				
31								
32								
33	75,000		0					
34	15,000		0					
35								
36								
37								
38								
39								
40		0		-25,000				
41								
42								
43		135,000		0	135,000			
44		50,000		0	50,000			
45								
46								
47	25,000		0					
48		35,000		0	35,000			
49	20,000		0					
50		15,000		0	15,000			
51								
52	9,940,000	240,000	200,000	-35,000	240,000	0	0	0
53								
54								
55			*Net change in bank acount and bonds are					
56			"Not included below" because these					
57			changes do not reflect gain or loss. The					
58			purpose of this column is to calculate					
59			net gain or loss.					
60								

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.97 M. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust/Marital Trust (With GST Division) Plan

§14.97 M. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust/Marital Trust (With GST Division) Plan

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST							
2	FIRST DEATH (January 1, 2009)							
3	TRUE WORTH PECUNIARY MARITAL							
4		(1)	(2)	(3)	(4)	(5)	(6)	(7)
5								
6		DOD	DOD	Less	Net	Date of	Distribution Value	
7	Schedule of Assets	Title	Value	Debt	Value	Distribution	Trust	Non-Trust
8								
9	A. Real Estate							
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10	500,000	
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10	150,000	
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10	250,000	
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000	1-Mar-10	8,000,000	
14								
15	B. Securities							
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10	40,000	
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-10	28,500	
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10	39,000	
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10	40,500	
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10	250,000	
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10	80,000	
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10	140,000	
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10	75,000	
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10	147,000	
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10	0	
26	11. Mutual Fund						25,000	
27								
28	C. Bank Accounts							
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09		5,000
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10	40,000	
31								
32	D. Promissory Notes							
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10	75,000	
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10	15,000	
35								
36	E. Business Interests							
37								
38	F. Life Insurance							
39	1. Policy on Hank	Irrev/Tr	N/A					
40	2. Policy on Hank	Non-Trust	25,000	0	25,000	1-Jan-09		0
41	(Wendy is beneficiary)							
42	G. Annuities & Retirement							
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09		135,000
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09		50,000
45								
46	H. Miscellaneous Property							
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10	25,000	
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09		35,000
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10	20,000	
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09		15,000
51								
52	TOTALS:		10,025,000	0	10,025,000		9,940,000	240,000
53								
54			DODeath	DODist				
55		CP Trust	9,500,000	9,690,000				
56		HSP Trust	0	0				
57		WSP Trust	250,000	250,000				
58		JT	65,000	55,000				
59		Non-Trust	210,000	185,000				
60		Total	10,025,000	10,180,000				

Print

	I	J	K	L	M	N	O
1							
2							
3							
4	(8)		(9)	(10)	(11)		(12)
5				Surv.Share	Marital Share		Credit Share
6	Net Change		Wendy	Survivor's	Exempt Mar	Non-Exempt Mar	Credit
7	Trust	Non-Trust	Outright	Trust	Trust	Trust	Trust
8							
9							
10	0						
11	0						
12	0						
13	0						
14							
15							
16	6,500						
17	11,000						
18	9,250						
19	20,000						
20	26,250						
21	-5,000						
22	50,000						
23	25,000						
24	57,000						
25	-50,000	* Not included below					
26							
27							
28							
29		-10,000	5,000				
30	15,000	* Not included below					
31							
32							
33	0						
34	0						
35							
36							
37							
38							
39							
40		-25,000					
41							
42							
43		0	135,000				
44		0	50,000				
45							
46							
47	0						
48		0	35,000				
49	0						
50		0	15,000				
51							
52	200,000	-35,000	240,000				
53							
54							
55	*Net change in bank acount and bonds are						
56	"Not included below" because these						
57	changes do not reflect gain or loss. The						
58	purpose of this column is to calculate						
59	net gain or loss.						
60							

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.98 N. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust (With GST Division)/Marital Trust Plan

§14.98 N. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Survivor's Trust/Credit Trust (With GST Division)/Marital Trust Plan

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST							
2	FIRST DEATH (January 1, 2006)							
3	TRUE WORTH PECUNIARY MARITAL							
4		(1)	(2)	(3)	(4)	(5)	(6)	(7)
5								
6		DOD	DOD	Less	Net	Date of	Distribution Value	
7	Schedule of Assets	Title	Value	Debt	Value	Distribution	Trust	Non-Trust
8								
9	A. Real Estate							
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-07	500,000	
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-07	150,000	
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-07	250,000	
13	4. 80% Commercial Property	Trust/CP	4,000,000	0	4,000,000	1-Mar-07	4,000,000	
14								
15	B. Securities							
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-07	40,000	
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-07	28,500	
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-07	39,000	
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-07	40,500	
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-07	250,000	
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-07	80,000	
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-07	140,000	
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-07	75,000	
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-07	147,000	
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-07	0	
26	11. Mutual Fund						25,000	
27								
28	C. Bank Accounts							
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-06		5,000
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-07	40,000	
31								
32	D. Promissory Notes							
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-07	75,000	
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-07	15,000	
35								
36	E. Business Interests							
37								
38	F. Life Insurance							
39	1. Policy on Hank	Irrev/Tr	N/A					
40	2. Policy on Hank	Non-Trust	25,000	0	25,000	1-Jan-06		0
41	(Wendy is beneficiary)							
42	G. Annuities & Retirement							
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-06		135,000
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-06		50,000
45								
46	H. Miscellaneous Property							
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-07	25,000	
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-06		35,000
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-07	20,000	
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-06		15,000
51								
52	TOTALS:		6,025,000	0	6,025,000		5,940,000	240,000
53								
54		DODeath	DODist					
55	CP Trust	5,500,000	5,690,000					
56	HSP Trust	0	0					
57	WSP Trust	250,000	250,000					
58	JT	65,000	55,000					
59	Non-Trust	210,000	185,000					
60	Total	6,025,000	6,180,000					
61								

Print

	I	J	K	L	M	N	O	P
1								
2								
3								
4		(8)	(9)	(10)	(11)	(12)		(13)
5				Surv.Share	Marital Share	Credit Share		Comments
6		Net Change	Wendy	Survivor's		Exempt Credit	Non-Exempt	
7	Trust	Non-Trust	Outright	Trust		Trust	Credit Trust	
8								
9								
10	0							
11	0							
12	0							
13	0							
14								
15								
16	6,500							
17	11,000							
18	9,250							
19	20,000							
20	26,250							
21	-5,000							
22	50,000							
23	25,000							
24	57,000							
25	-50,000	* Not included below						
26								
27								
28								
29		-10,000	5,000					
30	15,000	* Not included below						
31								
32								
33	0							
34	0							
35								
36								
37								
38								
39								
40		-25,000						
41								
42								
43		0	135,000					
44		0	50,000					
45								
46								
47	0							
48		0	35,000					
49	0							
50		0	15,000					
51								
52	200,000	-35,000	240,000	0	0	0	0	
53			Target:					
54			Needed:					
55	*Net change in bank acount and bonds are							
56	"Not included below" because these							
57	changes do not reflect gain or loss. The							
58	purpose of this column is to calculate							
59	net gain or loss.							
60								
61								

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.99 O. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Unusual Situations

§14.99 O. Form: Alternative Spreadsheet Showing Shares and Subtrusts Receiving Assets in Unusual Situations

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST							
2	FIRST DEATH (January 1, 2009)							
3	TRUE WORTH PECUNIARY MARITAL							
4		(1)	(2)	(3)	(4)	(5)	(6)	(7)
5								
6		DOD	DOD	Less	Net	Date of	Distribution Value	
7	Schedule of Assets	Title	Value	Debt	Value	Distribution	Trust	Non-Trust
8								
9	A. Real Estate							
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10	500,000	
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10	150,000	
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10	250,000	
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000	1-Mar-10	8,000,000	
14								
15	B. Securities							
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10	40,000	
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-10	28,500	
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10	39,000	
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10	40,500	
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10	250,000	
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10	80,000	
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10	140,000	
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10	75,000	
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10	147,000	
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10	0	
26	11. Mutual Fund						25,000	
27								
28	C. Bank Accounts							
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09		5,000
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10	40,000	
31								
32	D. Promissory Notes							
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10	75,000	
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10	15,000	
35								
36	E. Business Interests							
37								
38	F. Life Insurance							
39	1. Policy on Hank	Irrev/Tr	N/A					
40	2. Policy on Hank	Non-Trust	25,000	0	25,000	1-Jan-09		0
41	(Wendy is beneficiary)							
42	G. Annuities & Retirement							
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09		135,000
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09		50,000
45								
46	H. Miscellaneous Property							
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10	25,000	
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09		35,000
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10	20,000	
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09		15,000
51								
52	TOTALS:		10,025,000	0	10,025,000		9,940,000	240,000
53								
54		DODeath	DODist					
55	CP Trust	9,500,000	9,690,000					
56	HSP Trust	0	0					
57	WSP Trust	250,000	250,000					
58	JT	65,000	55,000					
59	Non-Trust	210,000	185,000					
60	Total	10,025,000	10,180,000					

Print

	I	J	K	L	M	N	O	P	Q
1									
2									
3									
4	(8)		(9)	(10)	(11)	(12)		(13)	
5				Surv.Share	Marital Share	Credit	Share	Comments	
6	Net Change		Wendy	Survivor's	Marital	DisclaimerCredit	Subchapter S		
7	Trust	Non-Trust	Outright	Trust	Trust	Trust	Credit Trust		
8									
9									
10	0								
11	0								
12	0								
13	0								
14									
15									
16	6,500								
17	11,000								
18	9,250								
19	20,000								
20	26,250								
21	-5,000								
22	50,000								
23	25,000								
24	57,000								
25	-50,000	* Not included below						**Sold in admin**	
26								**From Non-T Funds**	
27									
28									
29		-10,000	5,000					**See Ex H hypo**	
30	15,000	* Not included below						**See Ex H hypo**	
31									
32									
33	0								
34	0								
35									
36									
37									
38									
39									
40		-25,000						**Proceeds to Trust**	
41									
42									
43		0	135,000						
44		0	50,000						
45									
46									
47	0								
48		0	35,000						
49	0								
50		0	15,000						
51									
52	200,000	-35,000	240,000	0	0	0	0	**Total in Trust**	
53			Target:						
54			Needed:						
55	*Net change in bank acount and bonds are								
56	"Not included below" because these								
57	changes do not reflect gain or loss. The								
58	purpose of this column is to calculate								
59	net gain or loss.								
60									

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.100 P. Form: Completed Allocation Spreadsheet Showing Shares and Subtrusts Receiving Assets, With Comments

§14.100 P. Form: Completed Allocation Spreadsheet Showing Shares and Subtrusts Receiving Assets, With Comments

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST							
2	FIRST DEATH (January 1, 2009)							
3	TRUE WORTH PECUNIARY MARITAL							
4		(1)	(2)	(3)	(4)	(5)	(6)	(7)
5								
6		DOD	DOD	Less	Net	Date of	Distribution Value	
7	Schedule of Assets	Title	Value	Debt	Value	Distribution	Trust	Non-Trust
8								
9	A. Real Estate							
10	1. Personal residence	Trust/CP	500,000	0	500,000	1-Mar-10	500,000	
11	2. Hawaii condo	Trust/CP	150,000	0	150,000	1-Mar-10	150,000	
12	3. Lake Tahoe Vacation Home	Trust/WSP	250,000	0	250,000	1-Mar-10	250,000	
13	4. 80% Commercial Property	Trust/CP	8,000,000	0	8,000,000	1-Mar-10	8,000,000	
14								
15	B. Securities							
16	1. Franklin Tax Exempt Fund	Trust/CP	33,500	0	33,500	1-Mar-10	40,000	
17	2. Georgia Pac, 225 sh	Trust/CP	17,500	0	17,500	1-Mar-10	28,500	
18	3. Merck, 275 shares	Trust/CP	29,750	0	29,750	1-Mar-10	39,000	
19	4. Home Depot, 400 shares	Trust/CP	20,500	0	20,500	1-Mar-10	40,500	
20	5. Fleetwood stock, 2016 sh	Trust/CP	223,750	0	223,750	1-Mar-10	250,000	
21	6. National R.V., 2045 shares	Trust/CP	85,000	0	85,000	1-Mar-10	80,000	
22	7. IBM, 1730 shares	Trust/CP	90,000	0	90,000	1-Mar-10	140,000	
23	8. ITT, 877 shares	Trust/CP	50,000	0	50,000	1-Mar-10	75,000	
24	9. Mobil Oil, 388 shares	Trust/CP	90,000	0	90,000	1-Mar-10	147,000	
25	10. U.S. Savings Bond	Trust/CP	50,000	0	50,000	1-Mar-10	0	
26	11. Mutual Fund		0				25,000	
27								
28	C. Bank Accounts							
29	1. Checking acct.	JT	15,000	0	15,000	1-Jan-09		5,000
30	2. Savings acct	Trust/CP	25,000	0	25,000	1-Mar-10	40,000	
31								
32	D. Promissory Notes							
33	1. Secured note	Trust/CP	75,000	0	75,000	1-Mar-10	75,000	
34	2. Unsecured note	Trust/CP	15,000	0	15,000	1-Mar-10	15,000	
35								
36	E. Business Interests							
37								
38	F. Life Insurance							
39	1. Policy on Hank	Irrev/Tr	N/A					
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25,000	0	25,000	1-Jan-09		0
41								
42	G. Annuities & Retirement							
43	1. Hank's retirement plan	Non-Trust	135,000	0	135,000	1-Jan-09		135,000
44	2. Wendy's IRA	Non-Trust	50,000	0	50,000	1-Jan-09		50,000
45								
46	H. Miscellaneous Property							
47	1. Household effects	Trust/CP	25,000	0	25,000	1-Mar-10	25,000	
48	2. Dodge Ram Dually	JT	35,000	0	35,000	1-Jan-09		35,000
49	3. Classic car	Trust/CP	20,000	0	20,000	1-Mar-10	20,000	
50	4. Sea Ray ski boat	JT	15,000	0	15,000	1-Jan-09		15,000
51								
52			10,025,000	0	10,025,000		9,940,000	240,000
53								
54		DODeath	DODist					
55	CP Trust	9,500,000	9,690,000					
56	HSP Trust	0	0					
57	WSP Trust	250,000	250,000					
58	JT	65,000	55,000					
59	Non-Trust	210,000	185,000					
60	Total	10,025,000	10,180,000					
61								
62	Total DODeath value of Trust	9,750,000 ←	2					
63								

Print

	I	J	K	L	M	N	O	P	Q	R
1										
2										
3										
4	(8)		(9)	(10)	(11)	(12)		(13)		
5				Surv.Share	Credit Share	Marital Share		Comments		
6	Net Change		Wendy	Survivor's	Credit	Exempt	Nonexempt			
7	Trust	Non-Trust	Outright	Trust	Trust	Trust	Trust			
8										
9										
10	0			500,000						
11	0				75,000		75,000			
12	0			250,000						
13	0			4,086,963	2,807,512	253,737	851,787			
14										
15										
16	6,500			40,000						
17	11,000			28,500						
18	9,250			39,000						
19	20,000			40,500						
20	26,250				250,000					
21	-5,000			80,000						
22	50,000				140,000					
23	25,000				75,000					
24	57,000			147,000						
25	-50,000	* Not included below						Sold during administration		
26				25,000				From Non-Trust Funds		
27										
28										
29		-10,000	5,000					See Exhibit H hypo		
30	15,000	* Not included below		29,287			10,713	See Exhibit H hypo		
31										
32										
33	0			75,000						
34	0			15,000						
35										
36										
37										
38										
39										
40		-25,000						Proceeds to Trust		
41										
42										
43		0	135,000							
44		0	50,000							
45										
46										
47	0			25,000						
48		0	35,000							
49	0			20,000						
50		0	15,000							
51										
52	200,000	-35,000	240,000	5,401,250	3,347,512	253,737	937,500	Total in Trust		
53			Target:	5,401,250	3,347,512	253,737	937,500	9,939,999		
54			Needed:	0	0	0	0			
55				A	B	CB	D	1		
56	*Net change in bank acount and bonds are									
57	"Not included below" because these changes									
58	do not reflect gain or loss. The purpose of this									
59	column is to calculate net gain or loss.									
60										
61										
62										
63										

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.101 Q. Form: Table Showing Expanded View of How Targets Were Calculated

§14.101 Q. Form: Table Showing Expanded View of How Targets Were Calculated

Title	Date of Death Value	Date of Dist. Value
CP Trust	9,500,000	9,690,000
HSP Trust	0	0
WSP Trust	250,000	250,000
JT	65,000	55,000
Non-Trust	210,000	185,000
Total	10,025,000	10,177,500
Total in Trust @ DO Dist		9,940,000
Reimburse SS		(37,500)
SS Sep. Prop.		(250,000)
Residence to SS		(500,000)
Household to SS		(25,000)
Subtotal		9,127,500
DS Expense		(50,000)
Subject to division		9,077,500
SS ½ share		4,538,750
Decedent's Share @ DO Dist		4,538,750

Calculate Survivor's Trust	
Total Trust Value @ DO Dist	9,940,000
less	
Dec. Adj. Share @ DO Dist	4,538,750
Total Survivor's Trust	5,401,250
Calculate Decedent's Adj. Share @ DO Death	
Total Trust Value @ DO Death	9,750,000
Less: SS Sep. Prop.	250,000
Total CP Trust Value @ DO Death	9,500,000
1/2 CP Trust @ DO Death	4,750,000
Less: Specific Bequests to SS	262,500
Decedent's Adjusted Share @ DO Death	4,487,500

Targets

Marital Share Target		Pecuniary Exempt Marital Trust Target	
Dec. Adj. Share @ DO Death	4,487,500	GST Exemption	3,500,000
Less:			
All expenses claimed on 706	(50,000)		
Less:		Less:	
Remaining unified credit	(3,260,000)	Remaining unified credit	(3,260,000)
	1,177,500		240,000
Plus: Interest on pecuniary share	13,737	Plus: Interest on Marital Share	13,737
Marital Share Target	1,191,237	Pecuniary Exempt Marital Trust Target	253,737
Credit Trust Target		Nonexempt Marital Trust Target	

Dec. Adj. Share @ DO Dist	4,538,750	Marital Share Target	1,191,237
Less:		Less: Pecuniary Exempt	
Marital Share Target	(1,191,237)	Marital Trust Target	(253,737)
Credit Trust Target	3,347,512	Nonexempt Marital Trust Target	937,500

Marital Share = $1,191,237

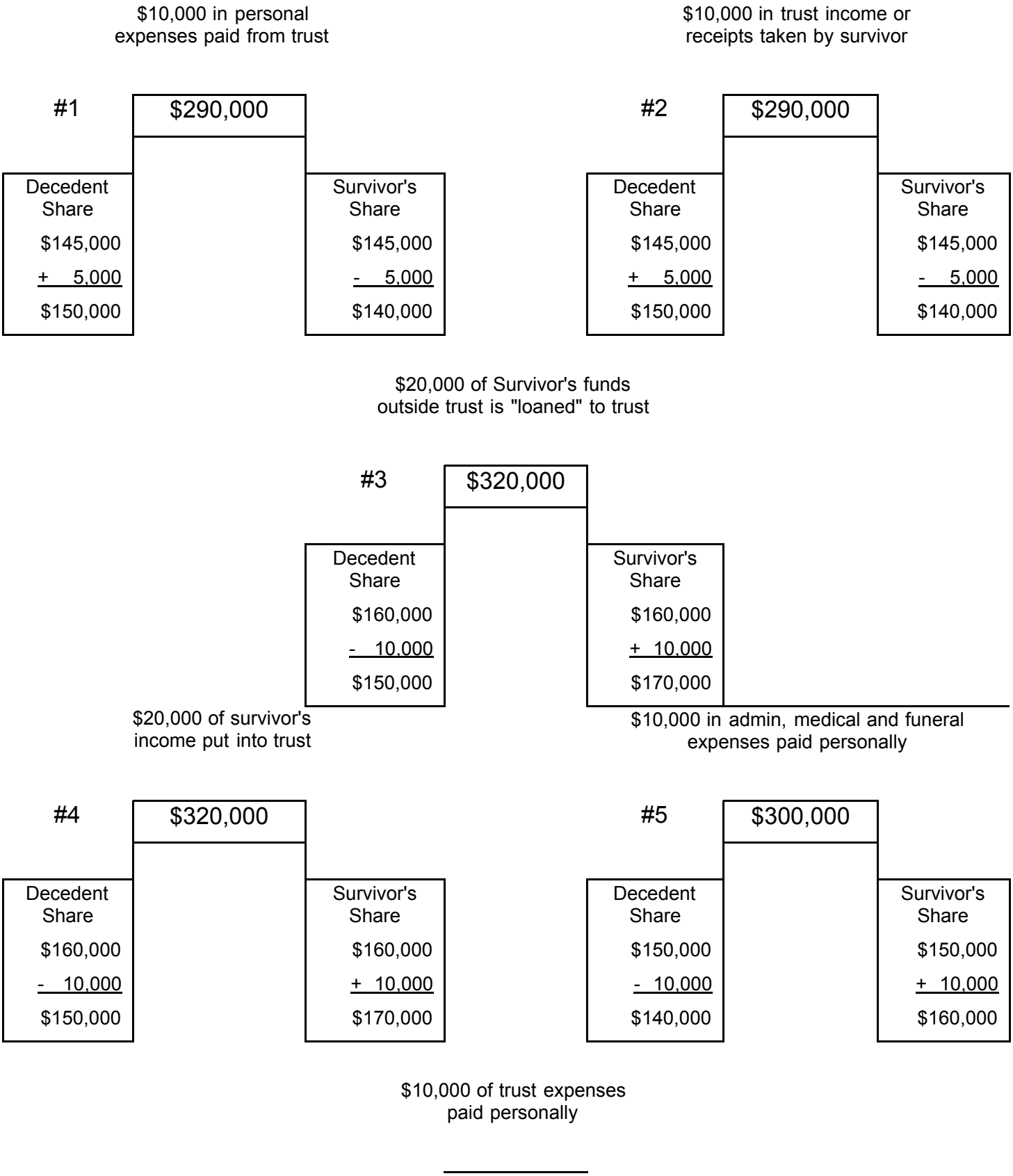
Credit Share = $3,347,512

Decedent's Total Share = $4,538,750

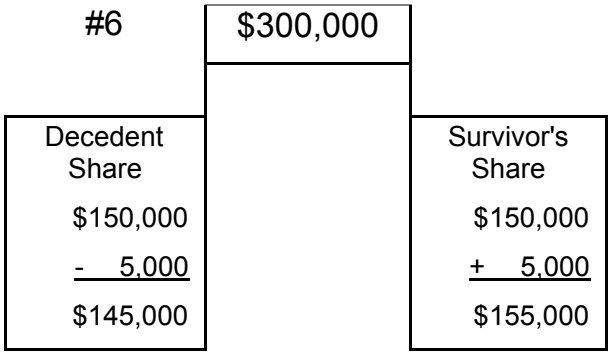
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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.102 R. Form: Flowchart Showing Adjustments for Expenses Improperly Paid From Family Trust, Trust Income Improperly Paid to Survivor, and Survivor's Loans to Trust

§14.102 R. Form: Flowchart Showing Adjustments for Expenses Improperly Paid From Family Trust, Trust Income Improperly Paid to Survivor, and Survivor's Loans to Trust



#6



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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.103 S. Form: Completed Allocation Spreadsheets Showing Shares and Subtrusts Receiving Assets, With Formulas

§14.103 S. Form: Completed Allocation Spreadsheets Showing Shares and Subtrusts Receiving Assets, With Formulas

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H
1	TRUST ASSET ALLOCATION FOR THE RICH FAMILY TRUST							
2	FIRST DEATH (January 1, 2009)							
3	TRUE WORTH PECUNIARY MARITAL							
4		(1)	(2)	(3)	(4)	(5)	(6)	(7)
5								
6		DOD	DOD	Less	Net	Date of	Distribution Value	
7	Schedule of Assets	Title	Value	Debt	Value	Distribution	Trust	Non-Trust
8								
9	A. Real Estate							
10	1. Personal residence	Trust/CP	500000	0	=(C10-D10)	40238	500000	
11	2. Hawaii condo	Trust/CP	150000	0	=(C11-D11)	40238	150000	
12	3. Lake Tahoe Vacation Home	Trust/WSP	250000	0	=(C12-D12)	40238	250000	
13	4. 80% Commercial Property	Trust/CP	8000000	0	=(C13-D13)	40238	8000000	
14								
15	B. Securities							
16	1. Franklin Tax Exempt Fund	Trust/CP	33500	0	=(C16-D16)	40238	40000	
17	2. Georgia Pac, 225 sh	Trust/CP	17500	0	=(C17-D17)	40238	28500	
18	3. Merck, 275 shares	Trust/CP	29750	0	=(C18-D18)	40238	39000	
19	4. Home Depot, 400 shares	Trust/CP	20500	0	=(C19-D19)	40238	40500	
20	5. Fleetwood stock, 2016 sh	Trust/CP	223750	0	=(C20-D20)	40238	250000	
21	6. National R.V., 2045 shares	Trust/CP	85000	0	=(C21-D21)	40238	80000	
22	7. IBM, 1730 shares	Trust/CP	90000	0	=(C22-D22)	40238	140000	
23	8. ITT, 877 shares	Trust/CP	50000	0	=(C23-D23)	40238	75000	
24	9. Mobil Oil, 388 shares	Trust/CP	90000	0	=(C24-D24)	40238	147000	
25	10. U.S. Savings Bond	Trust/CP	50000	0	=(C25-D25)	40238	0	
26	11. Mutual Fund		0				25000	
27								
28	C. Bank Accounts							
29	1. Checking acct.	JT	15000	0	=(C29-D29)	39814		5000
30	2. Savings acct	Trust/CP	25000	0	=(C30-D30)	40238	40000	
31								
32	D. Promissory Notes							
33	1. Secured note	Trust/CP	75000	0	=(C33-D33)	40238	75000	
34	2. Unsecured note	Trust/CP	15000	0	=(C34-D34)	40238	15000	
35								
36	E. Business Interests							
37								
38	F. Life Insurance							
39	1. Policy on Hank	Irrev/Tr	N/A					
40	2. Policy on Hank (Wendy is bene)	Non-Trust	25000	0	=(C40-D40)	39814		0
41								
42	G. Annuities & Retirement							
43	1. Hank's retirement plan	Non-Trust	135000	0	=(C43-D43)	39814		135000
44	2. Wendy's IRA	Non-Trust	50000	0	=(C44-D44)	39814		50000
45								
46	H. Miscellaneous Property							
47	1. Household effects	Trust/CP	25000	0	=(C47-D47)	40238	25000	
48	2. Dodge Ram Dually	JT	35000	0	=(C48-D48)	39814		35000
49	3. Classic car	Trust/CP	20000	0	=(C49-D49)	40238	20000	
50	4. Sea Ray ski boat	JT	15000	0	=(C50-D50)	39814		15000
51								
52			=SUM(C10:C50)	=SUM(D10:D50)	=SUM(E10:E50)		=SUM(G10:G50)	=SUM(H10:H50)
53								
54		DODeath	DODist					
55	CP Trust	=(C52-C12-B58-B59)	=(G52-G12)					
56	HSP Trust	0	0					
57	WSP Trust	=(C12)	=(G12)					
58	JT	=(C29+C48+C50)	=(H29+H48+H50)					
59	Non-Trust	=(C40+C43+C44)	=(H40+H43+H44)					
60	Total	=SUM(B55:B59)	=SUM(C55:C59)					
61								
62	Total DODeath value of Trust	=B55+B57	← 2					
63								

Print

	I	J	K	L	M	N	O	P
1								
2								
3								
4	(8)		(9)	(10)	(11)	(12)		(13)
5				Surv.Share	Credit Share	Marital Share		Comments
6	Net Change		Wendy	Survivor's	Credit	Exempt	Nonexempt	
7	Trust	Non-Trust	Outright	Trust	Trust	Trust	Trust	
8								
9								
10	=(G10-E10)			500000				
11	=(G11-E11)				75000		75000	
12	=(G12-E12)			250000				
13	=(G13-E13)			4086963	2807512	253737	851787	
14								
15								
16	=(G16-E16)			40000				
17	=(G17-E17)			28500				
18	=(G18-E18)			39000				
19	=(G19-E19)			40500				
20	=(G20-E20)				250000			
21	=(G21-E21)			80000				
22	=(G22-E22)				140000			
23	=(G23-E23)				75000			
24	=(G24-E24)			147000				
25	=(G25-E25)	* Not included below						Sold during administratio
26				25000				From Non-Trust Funds
27								
28								
29		=(H29-C29)	5000					See Exhibit H hypo
30	=(G30-C30)	* Not included below		29287			10713	See Exhibit H hypo
31								
32								
33	=(G33-C33)			75000				
34	=(G34-C34)			15000				
35								
36								
37								
38								
39								
40		=(H40-C40)						Proceeds to Trust
41								
42								
43		=(H43-E43)	135000					
44		=(H44-E44)	50000					
45								
46								
47	=(G47-E47)			25000				
48		=(H48-E48)	35000					
49	=(G49-E49)			20000				
50		=(H50-E50)	15000					
51								
52	=SUM(I8:I51)-(I30+I25)	=SUM(J10:J50)	=SUM(K10:K50)	=SUM(L10:L50)	=SUM(M10:M50)	=SUM(N10:N50)	=SUM(O10:O50)	Total in Trust
53			Target:	5401250	3347512	253737	937500	=SUM(L53:O53)
54			Needed:	=(L53-L52)	=(M53-M52)	=(N53-N52)	=(O53-O52)	
55				A	B	C	D	1
56	*Net change in bank acount and bonds are							
57	"Not included below" because these changes							
58	do not reflect gain or loss. The purpose of this							
59	column is to calculate net gain or loss.							
60								
61								
62								
63								

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.104 T. Form: Table Showing Allocation to Various Subtrusts

§14.104 T. Form: Table Showing Allocation to Various Subtrusts

ESTATE OF HANK T. RICH

THE HANK T. RICH CREDIT TRUST Tax ID # 68-5764318	**HANK T. RICH'S EXEMPT MARITAL TRUST Tax ID # 68-5764313**
SUMMARY Wendy M. Rich is the trustee Not revocable or amendable Wendy M. Rich receives all trust net income Principal for health, support, and education In existence until Wendy M. Rich's death Passes free of estate tax Annual fiduciary income tax returns	**SUMMARY** Wendy M. Rich is the trustee Not revocable or amendable Wendy M. Rich receives all trust net income Principal for health, support, and education In existence until Wendy M. Rich's death Included in Wendy M. Rich's taxable estate Annual fiduciary income tax returns
TRUST ASSETS 1. 50% Hawaii condo 2. 32.8% commercial property interest 3. 2016 shares of Fleetwood stock 4. 1730 shares of IBM stock 5. 877 shares of ITT stock	**ASSETS** 1. 6.2% commercial property interest

THE HANK T. RICH NON-EXEMPT MARITAL TRUST Tax ID # 68-5764316	**THE WENDY M. RICH SURVIVOR'S TRUST Tax ID # 522-14-3701**	**WENDY M. RICH'S NON-TRUST ASSETS Tax ID # 552-14-3701**
SUMMARY Wendy M. Rich is the trustee Not revocable or amendable Wendy M. Rich receives all trust net income Principal for health, support and education In existence until Wendy M. Rich's death Included in Wendy M. Rich's taxable estate Annual fiduciary income tax returns	**SUMMARY** Wendy M. Rich is the trustee Revocable and amendable by Wendy M. Rich Use income and principal as he/she wishes Included in Wendy M. Rich's taxable estate Income reported on personal tax return	**SUMMARY** Assets not held in any trust Probate may be required Included in Wendy M. Rich's taxable estate Income reported on personal tax return
TRUST ASSETS 1. 50% Hawaii condo 2. 8.8% of commercial property interest	TRUST ASSETS 1. Personal Residence 2. Lake Tahoe vacation home	ASSETS 1. Checking account ($5000) 2. Hank's qualified retirement plan

	3. 52.2% of commercial property interest 4. Franklin Tax Exempt Fund 5. 225 shares Georgia Pacific 6. 275 shares Merck 7. 400 shares Home Depot 8. 2045 National RV 9. 388 shares Mobil Oil 10. Mutual Fund 11. Secured note 12. Unsecured note 13. Household effects 14. Classic car	3. Wendy's IRA 4. Dodge Ram Dually 5. Sea Ray Ski Boat

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.104A U. Form: Decedent and Surviving Spouse's Target Calculation Worksheet

§14.104A U. Form: Decedent and Surviving Spouse's Target Calculation Worksheet

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G
1	**DECEDENT AND SURVIVING SPOUSE'S**						
2	**TARGET CALCULATION WORKSHEET**						
3							
4	**DETERMINING ALLOCATION BETWEEN SURVIVOR'S**						
5	**SHARE AND DECEDENT'S SHARE**						
6							
7							
8	**STEP 1:**						
9							
10	**DETERMINING THE ADJUSTED VALUE OF THE ESTATE**						
11							
12	Trust Assets -DOA-including all cash and assets						
13							
14	Deduct						
15	Non-Trust Income Deposited to Trust						
16	Non-Trust Assets Deposited to Trust						
17	Surviving Spouse's Loans to Trust						
18							=SUM(F15:F17)
19	Add						
20	Trust Income Depositied in Personal Account						
21	or Paid Out to Surviving Spouse						
22	Trust Assets transferred to SS or Surv Trust						
23	Non-Trust Expenses Paid by Trust						
24							=SUM(F21:F23)
25							
26	**Adjusted Trust Value (DOA)**						**=G12-G17+G24**
27							
28							
29	**STEP 2:**						
30							
31	**ALLOCATION BETWEEN THE DECEDENT'S AND SS's**						
32	**SHARE OF THE TRUST ESTATE**						
33							
34	**A. COMPUTING COMMUNITY PROPERTY SHARE OF TRUST**						
35							
36	Adjusted Trust Value (DOA)						=G26
37							
38	Deduct						
39	Decedent's Separate Property in Trust (DOA Value)						
40	All post-death income from Decedent's SP						
41	deposited into the Trust (if not already						
42	deducted in step 1 above)						
43	SS's Separate Property in Trust						
44	All post-death income from SS's SP						
45	deposited into the Trust (if not already						
46	deducted in step 1 above)						
47							=SUM(F39:F46)
48							
49	**Adjusted Community Property Trust Value (DOA)**						**=G36-G47**

Print

	A	B	C	D	E	F	G
50							
51	**B. COMPUTING DECEDENT'S ADJUSTED SHARE**						
52							
53	One-half Adjusted Community Property Trust Value (DOA)						=1/2*(G49)
54							
55	Deduct						
56	Decedent's interest in Specific Bequests to SS						
57							
58	1/2 deductions taken on 1041, 706, and expenses						
59	of last illness taken on 1040 already paid from Trust						
60							
61	Funeral Expenses Paid Outside Trust by SS						
62	Administrative Expenses Paid Outside Trust by SS						
63	Last Illness Expenses Paid Outside Trust by SS						
64	Other Trust Expenses Paid Outside Trust by SS						
65							
66							=SUM(F56:F64)
67							
68	Add						
69	Decedent's Separate Property in Trust					=F39	
70	All post-death income from Decedent's SP					=F40	
71	deposited into the Trust						
72							=SUM(F69:F70)
73							
74	**Decedent's Adjusted Share (DOA)**						**=G53-G66+G72**
75	(This value used on Allocation worksheets)						
76							
77							
78	**C. COMPUTING THE TARGET FOR SURVIVOR'S TRUST**						
79							
80	Trust Assets -DOA-including all cash and assets						=G12
81							
82	Deduct						
83	Decedent's Adjusted Share						=G74
84							
85							
86	**Target Amount for Survivor's Trust**						**=G80-G83**
87							
88	*State law specific						

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.104B V. Form: Subtrust Allocation Worksheet for Pecuniary Marital/Residuary Credit Formula With Date-of-Distribution Funding

§14.104B V. Form: Subtrust Allocation Worksheet for Pecuniary Marital/Residuary Credit Formula With Date-of-Distribution Funding

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H	I
1	**ALLOCATION OF DECEDENT'S ADJUSTED SHARE**								
2	**BETWEEN MARITAL AND CREDIT TRUSTS**								
3	**PECUNIARY MARITAL/RESIDUAL CREDIT**								
4	(True Worth Date-of-Distribution Funding)								
5									
6									
7	**STEP 1:**								
8									
9	Calculate Adjusted Applicable Exclusion Amount								
10		(This value is needed to complete Step 2 below)							
11									
12	Applicable Exclusion Amount								
13	($2,000,000 in 2006, 2007, 2008; $3,500,000 in 2009)								
14									
15	Deduct								
16	Lifetime Transfers								
17		(Other than annual exclusion amounts)							
18	Specific Bequests to other than Surviving Spouse								
19		(trust or non-trust)							
20									
21	Add								
22	Adjustment for 2031(c) exclusion (max of $500,000)								
23		(Qualified Conservation Easement)							
24									
25	**Adjusted Applicable Exclusion Amount**							**=H13-G16-G18+G23**	*
26		*(This value is inserted in Step 2 below)							
27									
28									
29	**STEP 2:**								
30									
31	Calculate the Decedent's Adjusted Share (Date of Death)								
32									
33	Date of Death Value of Trust								
34									
35	Deduct								
36	Decedent's Separate Property (in Trust)								
37	Survivor's Separate Property (in Trust)								
38									
39	**CP Value of Trust (Date of Death)**						=H33-G36-G37		
40									
41	1/2 of CP Value of Trust (Date of Death)							=G39/2	
42									
43	Deduct								
44	Specific Bequests to Surviving Spouse								
45									
46	Add								
47	Decedent's Separate Property (in Trust-Date of						=G36		
48		of Death Value)							
49									
50	**Decedent's Adjusted Share (Date of Death)**							**=H41-G44+G47**	
51									
52									
53	**STEP 3:**								
54									
55	Calculate Marital Trust Target Amount								
56									
57	Decedent's Adjusted Share of Trust at Date								
58		Death (From above)						=H50	
59									

Print

	A	B	C	D	E	F	G	H	I
60	Deduct								
61	All deductions claimed on 706								
62									
63	2032A reduction (up to $940,000 for 2007;								
64	$960,000 for 2008; $1,000,000 for 2009)								
65	*Adjusted Applicable Exclusion Amount (from above)						=H25	*	
66								=H58-G61-G63-G65	
67	Add								
68	Interest owed to pecuniary Marital Trust						=(0.07/12*2*(H66))		
69									
70	**Marital Trust Target Amount**							**=H66+G68**	
71									
72									
73	**STEP 4:**								
74									
75	Calculate Credit Trust Target Amount								
76									
77	Decedent's Adjusted Share of Trust at Date								
78	of Allocation						='Form A'!G74		
79	(From Target Calculation Worksheet-Form A)								
80									
81	Deduct								
82	Marital Trust Target Amount							=H70	
83	(From above)								
84									
85	**Credit Trust Target Amount**							**=G78-H82**	
86									
87									
88	**STEP 5:**								
89									
90	Determine Exempt Marital Trust Amount								
91									
92	Unused GST Exemption (amount of taxable								
93	lifetime transfers to non-skip persons)								
94									
95	Add:								
96	Interest owed to Pecuniary Exempt Marital Trust						=(0.07/12*2*(H66))		
97	(GST exemption not used by Credit Trust)								
98									
99	**PECUNIARY EXEMPT MARITAL TRUST TARGET:**							**=G92+G96**	
100									
101									
102	**STEP 6:**								
103									
104	Determine Residual Non-Exempt Marital Trust Amount								
105									
106	Marital Trust Target Amount						=H66+G68		
107									
108	Deduct:								
109	Pecuniary Exempt Marital Trust Target						=H99		
110									
111	**RESIDUAL NONEXEMPT MARITAL TRUST TARGET:**							**=G106-G109**	

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.104C W. Form: Subtrust Allocation Worksheet for Pecuniary Credit/Residuary Marital Formula With Date-of-Distribution Funding

§14.104C W. Form: Subtrust Allocation Worksheet for Pecuniary Credit/Residuary Marital Formula With Date-of-Distribution Funding

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H
1	**ALLOCATION OF DECEDENT'S ADJUSTED SHARE**							
2	**BETWEEN MARITAL AND CREDIT TRUSTS**							
3	**PECUNIARY CREDIT/RESIDUAL MARITAL**							
4	(True Worth Date-of-Distribution Funding)							
5								
6	**STEP 1:**							
7								
8	Calculate Applicable Exclusion Amount							
9	(This value is needed to complete step 2 below)							
10								
11	Applicable Exclusion Amount							
12	($2,000,000 in 2006, 2007, 2008; $3,500,000 in 2009)							
13								
14	Deduct							
15	Lifetime Transfers							
16	(Other than annual exclusion amounts)							
17	Specific Bequests to other than Surviving Spouse							
18	(trust or non-trust)							
19								
20	Add							
21	Adjustment for 2031(c) exclusion (max of $500,000)							
22	(Qualified Conservation Easement)							
23								
24	**Adjusted Applicable Exclusion Amount**							**=H11-G15-G17+G22**
25	*(This value is inserted below)							
26								
27								
28	**STEP 2:**							
29								
30	Calculate the Decedent's Adjusted Share (Date of Death)							
31								
32	Date of Death Value of Trust							
33								
34	Deduct							
35	Decedent's Separate Property (in Trust)							
36	Survivor's Separate Property (in Trust)							
37								
38	**CP Value of Trust (Date of Death)**						=H32-G35-G36	
39								
40	1/2 of CP Value of Trust (Date of Death)							=G38/2
41								
42	Deduct							
43	Specific Bequests to Surviving Spouse							
44								
45	Add							
46	Decedent's Separate Property (in Trust-						=G35	
47	Date of Death)							
48								
49	**Decedent's Adjusted Share (Date of Death)**							**=H40-G43+G46**
50								
51								

Print

	A	B	C	D	E	F	G	H
52	**STEP 3:**							
53								
54	Calculate Credit Trust Amount							
55								
56	*Adjusted Applicable Exclusion Amount (from above)							=H24
57								
58	Deduct							
59	Paid expenses deducted on 1041							
60								
61	Add							
62	Unpaid expenses claimed on 706							
63	2032A Reduction ($960,000 in 2008; $1,000,000 in 2009)							
64	Interest owed to pecuniary Credit Trust (14 mo.)						=(0.07/12*2*(H56-G59+G62+G63))	
65								
66	**CREDIT TRUST TARGET AMOUNT**							**=H56-G59+G62+G63+G64**
67								
68	**STEP 4:**							
69								
70	Calculate Marital Trust Target Amount							
71								
72	Decedent's Adjusted Share of Trust at Date of Allocation Values							='Form A'!G74
73	(From Target Calculation Worksheet)							
74								
75	Deduct							
76	Credit Trust Target Amount						=H66	
77	(From Above)							
78								
79	**MARITAL TRUST TARGET AMOUNT**							**=H72-G76**

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.104D X. Form: Subtrust Allocation Worksheet for Pecuniary Formula With Fairly Representative Date-of-Death Funding or Fractional Share Formula

§14.104D X. Form: Subtrust Allocation Worksheet for Pecuniary Formula With Fairly Representative Date-of-Death Funding or Fractional Share Formula

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H
1	**ALLOCATION OF DECEDENT'S ADJUSTED SHARE**							
2	**BETWEEN MARITAL AND CREDIT TRUSTS**							
3	(Either Pecuniary Fairly Representative Date-of-Death Funding							
4	or Fractional Share Fromula)							
5								
6	**STEP 1:**							
7								
8	Calculate Adjusted Applicable Exclusion Amount							
9	(This value is needed to complete Step 2 below)							
10								
11	Applicable Exclusion							
12	($2,000,000 in 2006, 2007, 2008; $3,500,000 in 2009)							
13								
14	Deduct							
15	Lifetime Transfers							
16	(Other than annual exclusion amounts)							
17	Specific Bequests to other than Surviving Spouse							
18	(trust or non-trust)							
19								
20	Add							
21	2032A Reduction ($960,000 in 2008; $1,000,000 in 2009)							
22	Adjustment for 2031(c) exclusion (max of $500,000)							
23	(Qualified Conservation Easement)							
24								
25	**Adjusted Applicable Exclusion Amount**						**=G12-F16-F18+F21+F23**	*
26	*(This value is inserted in Step 2 below)							
27								
28	**STEP 2:**							
29								
30	Calculate the Decedent's Adjusted Share (Date of Death)							
31								
32	Date of Death Value of Trust							
33								
34	Deduct							
35	Decedent's Separate Property (in Trust)							
36	Survivor's Separate Property (in Trust)							
37								
38	**CP Value of Trust (Date of Death)**						**=G32-F35-F36**	
39								
40	1/2 of CP Value of Trust (Date of Death)						=G38/2	
41								
42	Deduct							
43	Specific bequests to Surviving Spouse							
44								
45	Add							
46	Decedent's Separate Property (in Trust-Date of					=F35		
47	of Death Value)							
48								
49	**Decedent's Adjusted Share (Date of Death)**						**=G40-F43+F46**	
50								
51								
52	Calculate Total Increase or Decrease in Decedent's Share							
53								
54	Decedent's Adjusted Share (DOA) - Decedent's Share (Date of Death)						=(('Form A'!G74)-G49)	
55	(From Form A and Above)							
56								
57	**Total Change in Decedent's Share:**						**=G54**	
58								

Print

	A	F	G
59			
60	Decedent's Adjusted Share of Trust at Date of Death Values		=G49
61	(From Above)		
62			
63	**Credit Trust Ratio:**		
64	(Adjusted Applicable Exclusion Amount divided		=G25/G49
65	by Decedent's Adjusted Share--Date of Death)		
66			
67	**Marital Trust Ratio:**		=1-G64
68	(1 - Credit Trust Ratio)		
69			
70	**STEP 3:**		
71			
72	Calculate Credit Trust Target Amount		
73			
74	Adjusted Applicable Exclusion Amount		
75	(including 2032A reduction)		=G25
76			
77	Add:		
78	Unpaid expenses deducted on 706		
79	Fractional share of Increase or Decrease	=G64*G57	
80	of Decedent's Share: (CT Ratio Times		
81	Total Change in Decedent's Share)		
82	Deduct:		
83	Paid expenses deducted on 1041		
84			
85	**CREDIT TRUST TARGET AMOUNT:**		**=G75+F78+F79-F83**
86			
87	Calculate Marital Trust Target Amount		
88			
89	Decedent's Adjusted Share (DOA):	='Form A'!G74	
90			
91	Deduct:		
92			
93	Credit Trust Target Amount:	=G85	
94			
95	**MARITAL TRUST TARGET AMOUNT:**		**=F89-F93**

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.104E Y. Form: Completed Decedent and Surviving Spouse's Target Calculation Worksheet

§14.104E Y. Form: Completed Decedent and Surviving Spouse's Target Calculation Worksheet

To save this Excel spreadsheet, right click here and choose Save Target As.



	A	B	C	D	E	F	G	H	I
1					**DECEDENT AND SURVIVING SPOUSE'S**				
2					**TARGET CALCULATION WORKSHEET**				
3									
4					**DETERMINING ALLOCATION BETWEEN SURVIVOR'S**				
5					**SHARE AND DECEDENT'S SHARE**				
6									
7									
8	**STEP 1:**								
9									
10	**DETERMINING THE ADJUSTED VALUE OF THE ESTATE**								
11									
12	Trust Assets -DOA-including all cash and assets						9,940,000.00		1
13									
14	Deduct								
15	Non-Trust Income Deposited to Trust					2,500.00			
16	Non-Trust Assets Deposited to Trust					25,000.00			
17	Surviving Spouse's Loans to Trust								
18							27,500.00		
19	Add								
20	Trust Income Deposited in Personal Account								
21	or paid out to Surviving Spouse								
22	Trust Assets transferred to SS or Surv Trust								
23	Non-Trust Expenses Paid by Trust								
24							0.00		
25									
26	**Adjusted Trust Value (DOA)**						**9,912,500.00**		
27									
28									
29	**STEP 2:**								
30									
31	**ALLOCATION BETWEEN THE DECEDENT'S AND SS's**								
32	**SHARE OF THE TRUST ESTATE**								
33									
34	**A. COMPUTING COMMUNITY PROPERTY SHARE OF TRUST**								
35									
36	Adjusted Trust Value (DOA)						9,912,500.00		
37									
38	Deduct								
39	Decedent's Separate Property in Trust (DOA Value)								
40	All post-death income from Decedent's SP								
41	deposited into the Trust (if not already								
42	deducted in step 1 above)								
43	SS's Separate Property in Trust					250,000.00			
44	All post-death income from SS's SP								
45	deposited into the Trust (if not already								
46	deducted in step 1 above)								
47							250,000.00		
48									
49	**Adjusted Community Property Trust Value (DOA)**						**9,662,500.00**		
50									

Print

	A	B	C	D	E	F	G	H	I
51	**B. COMPUTING DECEDENT'S ADJUSTED SHARE**								
52									
53	One-half Adjusted Community Property Trust Value (DOA)						4,831,250.00		
54									
55	Deduct								
56	Decedent's interest in Specific Bequests to SS					262,500.00			
57									
58	1/2 of all deductions taken on 1041, 706, and expenses								
59	of last illness taken on 1040 already paid from Trust					20,000.00			
60									
61	Funeral Expenses Paid Outside Trust by SS					5,000.00			
62	Administrative Expenses Paid Outside Trust by SS					5,000.00			
63	Last Illnes Expenses Paid Outside Trust by SS								
64	Other Trust Expenses Paid Outside Trust by SS								
65									
66							292,500.00		
67									
68	Add								
69	Decedent's Separate Property in Trust					0.00			
70	All post-death income from Decedent's SP					0.00			
71	deposited into the Trust								
72							0.00		
73									
74	**Decedent's Adjusted Share (DOA)**						**4,538,750.00**		
75	(This value used on Allocation worksheets)								
76									
77									
78	**C. COMPUTING THE TARGET FOR SURVIVOR'S TRUST**								
79									
80	Trust Assets -DOA-including all cash and assets						9,940,000.00		1
81									
82	Deduct								
83	Decedent's Adjusted Share						4,538,750.00		
84									
85									
86	**Target Amount for Survivor's Trust**						**5,401,250.00**		A
87									
88	*State law specific								

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.104F Z. Form: Completed Subtrust Allocation Worksheet for Pecuniary Marital/Residuary Credit Formula

§14.104F Z. Form: Completed Subtrust Allocation Worksheet for Pecuniary Marital/Residuary Credit Formula

To save this Excel spreadsheet, right click here and choose Save Target As.



ALLOCATION OF DECEDENT'S ADJUSTED SHARE
BETWEEN MARITAL AND CREDIT TRUSTS
PECUNIARY MARITAL/RESIDUAL CREDIT
(True Worth Date of Distribution Funding)

STEP 1:

Calculate Adjusted Applicable Exclusion Amount
(This value is needed to complete Step 2 below)

Applicable Exclusion Amount ($2,000,000 in 2006, 2007, 2008; $3,500,000 in 2009)		3,500,000.00
Deduct		
Lifetime Transfers (Other than annual exclusion amounts)	240,000.00	
Specific Bequests to other than Surving Spouse (trust or non-trust)		
Add		
Adjustment for 2031(c) exclusion (max of $500,000) (Qualified Conservation Easement)		
Adjusted Applicable Exclusion Amount		**3,260,000.00** *

*(This value is inserted in Step 2 below)

STEP 2:

Calculate the Decedent's Adjusted Share (Date of Death)

Date of Death Value of Trust		9,750,000.00	2
Deduct			
Decedent's Separate Property (in Trust)			
Survivor's Separate Property (in Trust)	250,000.00		
CP Value of Trust (Date of Death)	9,500,000.00		
1/2 of CP Value of Trust (Date of Death)		4,750,000.00	
Deduct			
Specific bequests to Surviving Spouse	262,500.00		
Add			
Decedent's Separate Property (in Trust-Date of of Death Value)	0.00		
Decedent's Adjusted Share (Date of Death)		**4,487,500.00**	

Print

	A	B	C	D	E	F	G	H	I	J
53	**STEP 3:**									
54										
55	Calculate Marital Trust Target Amount									
56										
57	Decedent's Adjusted Share of Trust at Date									
58	Death (From above)							4,487,500.00		
59										
60	Deduct									
61	All deductions claimed on 706						50,000.00			
62										
63	2032A reduction (up to $940,000 for 2007,									
64	$960,000 for 2008, $1,000,000 for 2009)									
65	*Adjusted Applicable Exclusion Amount (from above)						3,260,000.00	*		
66								1,177,500.00		
67	Add									
68	Interest owed to pecuniary Marital Trust						13,737.50			
69										
70	**Marital Trust Target Amount**							**1,191,237.50**		
71										
72										
73	**STEP 4:**									
74										
75	Calculate Credit Trust Target Amount									
76										
77	Decedent's Adjusted Share of Trust at Date									
78	of Allocation						4,538,750.00			
79	(From Target Calculation Worksheet-Form A)									
80										
81	Deduct									
82	Marital Trust Target Amount							1,191,237.50		
83	(From above)									
84										
85	**Credit Trust Target Amount**							**3,347,512.50**		B
86										
87										
88	**STEP 5:**									
89										
90	Determine Exempt Marital Trust Amount									
91										
92	Unused GST Exemption (amount of taxable						240,000.00			
93	lifetime transfers to non-skip persons)									
94										
95	Add:									
96	Interest owed to Pecuniary Exempt Marital Trust						13,737.50			
97										
98	**PECUNIARY EXEMPT MARITAL TRUST TARGET:**							**253,737.50**		C
99										
100										
101	**STEP 6:**									
102										
103	Determine Residual Non-Exempt Marital Trust Amount									
104										
105	Marital Trust Target Amount						1,191,237.50			
106										
107	Deduct:									
108	Pecuniary Exempt Marital Trust Target						253,737.50			
109										
110	**RESIDUAL NON-EXEMPT MARITAL TRUST TARGET:**							**937,500.00**		D
111										

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IX. CERTIFICATIONS OF TRUST

§14.105 A. Form: Certification of Trust for Family Trust

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CERTIFICATION OF TRUST
THE RICH FAMILY TRUST

I, WENDY M. RICH, hereby declare under penalty of perjury under the laws of the State of California and certify that:

1. On June 15, 1999, HANK B. RICH and WENDY M. RICH, as settlors, signed a Declaration of Trust which established a revocable living trust known as THE RICH FAMILY TRUST.

2. HANK B. RICH died on January 1, 2006, and WENDY M. RICH is the sole currently acting Trustee of the RICH FAMILY TRUST.

3. This Certificate is a true and correct representation of the terms of the Trust acting as an administrative trust.

4. The Trust is not of record in any court of law and has not been recorded in the real property records of any county.

5. The Trust has not been revoked, modified, or amended in any manner which would cause the representations contained herein to be incorrect.

6. The current beneficiary of the Trust is WENDY M. RICH.

7. Title to assets of the Trust should be taken in substantially the following form:

WENDY M. RICH, as Trustee of
THE RICH FAMILY TRUST
Tax Identification Number: _ _[*TIN*]**_ _**

8. The trust holds the following interest(s) in real property: _ _[*legal description of interest(s)*]**_ _.**

9. Under the terms of the Trust, the Trustee's powers include the powers set forth in Exhibit A attached hereto and incorporated herein by reference. The Trustee's powers also include all other powers and authority granted to trustees under the California Probate Code, as amended from time to time.

10. This Certificate is intended to serve as a "Certification of Trust" under California Probate Code §18100.5, as amended. Its purpose is to certify the existence of the trust, the identity and powers of the Trustee, the manner of taking title to assets, and to summarize some of the more important provisions of the Trust so that the Trustee can deal with third parties, such as financial institutions, stock transfer agents, brokerage houses, title companies, insurance companies, and others, without disclosing the entire Trust, which is a private and confidential document.

11. All third parties dealing with the Trustee may rely on this Certificate as a true statement of the provisions of the Trust described herein as of the date this Certificate is presented to such third party (regardless of the date of execution of this Certificate), unless the third party has actual knowledge that the representations contained herein are incorrect. The Trustee is expressly authorized to sue a third party who fails to rely on this Certificate and demand damages, including punitive damages, on behalf of the Settlor for such nonreliance.

Executed at Napa, California, on March 4, 2006.

_____

WENDY M. RICH, as Trustee of The RICH FAMILY TRUST, under Declaration of Trust
dated June 15, 1999

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF NAPA) ss
)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared WENDY M. RICH, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

EXHIBIT A

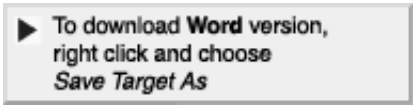
Trustee Powers

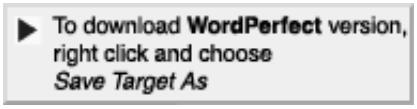
[*Attach Exhibit A listing Trustee Powers*]

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.106 B. Form: Certification of Trust for Credit Trust

§14.106 B. Form: Certification of Trust for Credit Trust





CERTIFICATION OF TRUST
THE _ _[*name*]_ _ CREDIT TRUST

I, _ _[*name*]_ _ hereby declare under penalty of perjury under the laws of the State of California and certify that:

1. On _ _[*date*]_ _, _ _[*name*]_ _ and _ _[*name*]_ _, as settlors, signed a Declaration of Trust which established a revocable living trust known as The _ _[*name*]_ _ Family Trust.

2. As a result of the death of _ _[*name*]_ _ on _ _[*date*]_ _, The _ _[*name*]_ _ Family Trust was divided into separate trusts, including The _ _[*name*]_ _ Credit Trust ("the Credit Trust").

3. _ _[*Name*]_ _ is the sole currently acting Trustee of the Credit Trust.

4. The Credit Trust is not of record in any court of law and has not been recorded in the real property records of any county.

5. The Credit Trust has not been revoked, modified, or amended in any manner which would cause the representations contained herein to be incorrect.

6. The Credit Trust is nonamendable and irrevocable.

7. _ _[*Name*]_ _ is the sole current beneficiary of the Credit Trust.

8. Title to assets of the Credit Trust should be taken in substantially the following form:

_ _[*Name*]_ _, Trustee of The _ _[*name*]_ _ Credit Trust

Tax Identification Number: _ _[*TIN*]_ _

9. The trust holds the following interest(s) in real property: _ _[*legal description of interest(s)*]_ _.

10. Under the terms of the Trust, the Trustee's powers include the powers set forth in Exhibit A attached hereto and incorporated herein by reference. The Trustee's powers also include all other powers and authority granted to trustees under the California Probate Code, as amended from time to time.

11. This Certificate is intended to serve as a "Certification of Trust" under California Probate Code §18100.5, as amended. Its purpose is to certify the existence of the trust, the identity and powers of the Trustee, the manner of taking title to assets, and to summarize some of the more important provisions of the Trust so that the Trustee can deal with third parties, such as financial institutions, stock transfer agents, brokerage houses, title companies, insurance companies, and others, without disclosing the entire Trust, which is a private and confidential document.

12. All third parties dealing with the Trustee may rely on this Certificate as a true statement of the provisions of the Trust described herein as of the date this Certificate is presented to such third party (regardless of the date of execution of this Certificate), unless the third party has actual knowledge that the representations contained herein are incorrect.

Executed at _ _[*city*]_ _, California, _ _[*date*]_ _.

_____
_ _[*Name*]_ _, as Trustee of The _ _[*Name*]_ _ Family Trust, under Declaration of Trust dated _ _[*date*]_ _

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF _ _[*name*]_ _) ss
)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name of trustee*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

EXHIBIT A

Trustee Powers

[*Attach Exhibit A listing Trustee Powers*]

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.107 C. Form: Certification of Trust for Survivor's Trust

§14.107 C. Form: Certification of Trust for Survivor's Trust

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

CERTIFICATION OF TRUST
THE _ _[*name*]_ _ SURVIVOR'S TRUST

I, _ _[*name*]_ _ hereby declare under penalty of perjury under the laws of the State of

California and certify that:

1. On _ _[*date*]_ _, _ _[*name*]_ _ and _ _[*name*]_ _, as settlors, signed a Declaration of Trust which established a revocable living trust known as The _ _[*name*]_ _ Family Trust.

2. As a result of the death of _ _[*name*]_ _ on _ _[*date*]_ _, The _ _[*name*]_ _ Family Trust was divided into separate trusts, including The _ _[*name*]_ _ Survivor's Trust. ("the Survivor's Trust").

3. _ _[*Name*]_ _ is the sole currently acting Trustee of The Survivor's Trust.

4. The Survivor's Trust is not of record in any court of law and has not been recorded in the real property records of any county.

5. The Survivor's Trust has not been revoked, modified, or amended in any mariner which would cause the representations contained herein to be incorrect.

6. _ _[*Name*]_ _ is the sole current beneficiary of the Survivor's Trust.

7. Title to assets of the Survivor's Trust should be taken in substantially the following form:

_ _[*Name*]_ _, Trustee of The _ _[*name*]_ _ Survivor's Trust.

Tax Identification Number: _ _[*TIN*]_ _

8. The trust holds the following interest(s) in real property: _ _[*legal description of interest(s)*]_ _.

9. Under the terms of the Trust, the Trustee's powers include the powers set forth in Exhibit A attached hereto and incorporated herein by reference. The Trustee's powers also include all other powers and authority granted to trustees under the California Probate Code, as amended from time to time.

10. This Certificate is intended to serve as a "Certification of Trust" under California Probate Code §18100.5, as amended. Its purpose is to certify the existence of the trust, the identity and powers of the Trustee, the manner of taking title to assets, and to summarize some of the more important provisions of the Trust so that the Trustee can deal with third parties, such as financial institutions, stock transfer agents, brokerage houses, title companies, insurance companies, and others, without disclosing the entire Trust, which is a private and confidential document.

11. All third parties dealing with the Trustee may rely on this Certificate as a true statement of the provisions of the Trust described herein as of the date this Certificate is presented to such third party (regardless of the date of execution of this Certificate), unless the third party has actual knowledge that the representations contained herein are incorrect.

Executed at _ _[*city*]_ _, California, _ _[*date*]_ _.

_____

_ _[*Name*]_ _, as Trustee of The _ _[*name*]_ _ Family Trust, under Declaration of Trust dated _ _[*date*]_ _

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF _ _[*name*]_ _) ss
)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name of trustee*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

EXHIBIT A

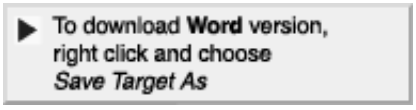
Trustee Powers

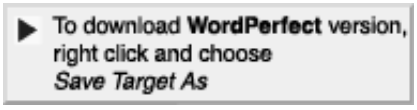
[*Attach Exhibit A listing Trustee Powers*]

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.108 X. FORM: AFFIDAVIT OF DEATH OF TRUSTEE

§14.108 X. FORM: AFFIDAVIT OF DEATH OF TRUSTEE





RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO:

_ _[*name*]_ _
_ _[*address*]_ _

MAIL TAX STATEMENTS TO:

_ _[*name of client*]_ _
_ _[*address*]_ _

ABOVE THIS LINE FOR RECORDER'S USE ONLY

AFFIDAVIT OF DEATH OF TRUSTEE

STATE OF CALIFORNIA, County of Napa:

_ _[*Name*]_ _ of legal age, being duly sworn, says:

On _ _[*date*]_ _, _ _[*name*]_ _ and _ _[*name*]_ _, as settlors, by a Trust Declaration created The _ _[*name*]_ _ Family Trust;

On _ _[*date*]_ _, the said settlors executed a Grant Deed, recorded _ _[*date*]_ _ in Volume _ _[*number*]_ _ Page _ _[*number*]_ _ in Official Records in the office of the Napa County Recorder, conveying to _ _[*name*]_ _ and _ _[*name*]_ _, as Trustees of the said Trust, the hereinafter described real property;

On _ _[*date*]_ _, _ _[*name*]_ _, one of the said Trustees, the same person as the decedent mentioned in the certified copy of Certificate of Death, attached hereto as Exhibit A, died;

The said Trust Declaration provides that _ _[*name*]_ _ thereupon became the Trustee of the said Trust, and having accepted the office of Trustee, is now qualified and acting Trustee of the said Trust;

The property hereinabove mentioned, commonly known as _ _[*address*]_ _, is described as follows:

LEGAL DESCRIPTION

A.P.N. _____

Dated: _ _[*date*]_ _

_____
_ _[*name*]_ _, as Trustee of The _ _[*name*]_ _ Family Trust, under Declaration of Trust dated _ _[*date*]_ _

STATE OF CALIFORNIA)
COUNTY OF _ _[*name*]_ _) ss
)

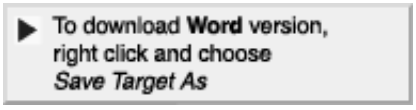
Subscribed and sworn to (or affirmed) before me on this _ _[*number*]_ _ day of _ _[*month*]_ _, 20_ _, by _ _[*name of trustee*]_ _, proved to me on the basis of satisfactory evidence to be the person who appeared before me.

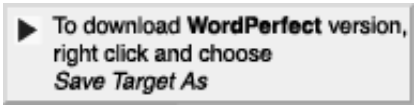
__[*Signature of officer*]__ [*Officer's seal*]

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Source: Estate Planning/California Trust Administration/14 Subtrust Allocation and Funding on the Death of the First Spouse/§14.109 XI. FORM: GRANT DEED FOR TRANSFERRING ASSETS OUT OF FAMILY TRUST

§14.109 XI. FORM: GRANT DEED FOR TRANSFERRING ASSETS OUT OF FAMILY TRUST





RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO:

_ _[*name of client*]_ _
_ _[*address*]_ _

MAIL TAX STATEMENTS TO:

_ _[*name of client*]_ _
_ _[*address*]_ _

_____
ABOVE THIS LINE FOR RECORDER'S USE ONLY

GRANT DEED

_ _[*Date*]_ _
_ _[*City*]_ _**, California** _ _[*ZIP Code*]_ _

Documentary Transfer Tax is $0.00.

A.P.N.: _____

The undersigned hereby declares that:

1. This transfer is made without consideration and is therefore exempt from Documentary Transfer Tax (California Revenue and Taxation Code §11911).

2. This transfer is an interspousal transfer under §63 of the California Revenue and Taxation Code and does not constitute a "change in ownership" for property tax purposes.

NOW THEREFORE, _ _[*name*]_ _**, as Trustee of The** _ _[*name*]_ _ **Family Trust, under Declaration of Trust dated** _ _[*date*]_ _**, hereby grants an undivided 50% interest to** _ _[*name*]_ _**, Trustee of The** _ _[*name*]_ _ **Survivor's Trust, and an undivided 50% interest to** _ _[*name*]_ _**, Trustee of The** _ _[*name*]_ _ **Credit Trust, for the benefit of the surviving spouse, that certain real property, situated in the State of California, County of** _ _[*name of county*]_ _**, City of** _ _[*name of city*]_ _**, and described as follows:**

Commonly known as: _ _[*Address*]_ _**, California**

Mail tax statements as directed above.

LEGAL

A.P.N. _____

Date: _ _[*date*]_ _

_____
_ _[*Name*]_ _**, as Trustee of The** _ _[*name*]_ _**, under Declaration of Trust dated**

_ _[*date*]_ _

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF _ _[*name*]_ _) ss
)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name of trustee*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

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§14.110 XII. COMPREHENSIVE PROCEDURAL CHECKLIST: TWO-PERSON TRUST—FIRST DEATH

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A. Step One: Prepare for First Meeting

- 1. First telephone call
- 2. Review trust instrument
- a. Identify subtrusts established at first death
- (1) Survivor's trust
- (2) Disclaimer trust
- (3) Credit trust
- (4) Marital trust
- b. Watch for second marriage situations
- c. General dispositive provisions
- d. Powers of appointment
- e. Prorata or Nonprorata distribution
- f. Disclaimers
- g. Estate tax clause
- h. "Administrative trust" clause
- i. Allocation of principal and income
- j. Report and account clause
- k. Prudent investor clause
- l. Trustee provisions
- m. Look for S corporation issues
- n. Power to divide trusts
- o. Payment of interest
- p. Gift provisions
- q. "Disqualified" persons
- r. Ambiguities and drafting errors
- s. Specific gifts (Prob C §21117(a))
- t. Identify marital deduction formula
- (1) Importance
- (2) Types of formulae
- (3) Advantages of true worth pecuniary marital
- (4) Disadvantages of true worth pecuniary marital
- (5) Advantages of fairly representative pecuniary marital
- (6) Disadvantages of fairly representative pecuniary marital

- (7) Advantages of fractional share
- (8) Disadvantages of fractional share
- (9) Conventional wisdom reconsidered
- (10) Problems of the unfunded or "stale" trust
- u. Generation-skipping transfer (GST) tax issues
- (1) Allocation of deceased spouse's exemption
- (2) Reverse QTIP election
- (3) GST-related considerations
- 3. Review pourover will
- 4. Review other documents
- 5. Prepare summary of estate planning documents

B. Step Two: First Meeting with Client (Successor Trustee)

- 1. Identify the client and determine scope of representation
- 2. Complete new client information sheet
- 3. Educate client about trust administration
- 4. Summarize the trust and distribution provisions
- 5. Collect asset information
- a. Review title to assets
- (1) Assets in the trust
- (2) Assets outside trust and subject to distribution by will
- (3) Assets outside trust but not subject to distribution by will
- b. Determine if legal action is required to collect assets into trust
- c. Estimate value of assets
- d. Discuss need for appraisals
- e. Identify need for investment advice and make referral to broker
- f. Identify dividend reinvestment accounts
- g. Identify out-of-state real property
- h. Identify depreciating or wasting assets
- i. Identify assets subject to special regulatory or contractual controls
- j. Identify safe deposit boxes and arrange for inventory
- k. Discuss insurance coverage
- l. Identify assets subject to options, escrows, or foreclosures
- m. Identify hazardous waste problems
- n. Have client sign authorization forms
- 6. Collect liability information
- a. Determine nature and amount of outstanding liabilities
- b. Funeral and last illness expenses chargeable solely to deceased spouse
- c. Identify potential creditors and outstanding lawsuits
- d. Discuss liability of trust for decedent's debts
- e. Consider court petition or agreement to allocate debts between trust and surviving spouse

- f. Discuss optional creditor's claim procedure
- g. Consider 1-year statute of limitations
- h. Identify outstanding guarantees
- 7. Collect beneficiary information
- 8. Review document list
- 9. Discuss fiduciary duties
- a. Source of trustee powers
- b. Standard of trust management
- c. Fiduciary relationship
- d. Protect, preserve, and make trust property productive
- e. Anti-commingling rule
- f. Duty to defend the trust
- g. Nondelegation of trustee powers
- h. Reporting and accounting requirement
- (1) Duty to keep beneficiaries informed
- (2) Mandatory accounting requirements for trusts established after July 1, 1987
- (3) Contents of account
- (4) Accounting on request of any beneficiary
- (5) Waivers
- (6) Recommend voluntary accounting even if not required
- (7) Consider obtaining court approval of accounting
- i. Record-keeping
- j. Principal and income law
- 10. Discuss trust checking account/handling of administrative trust transactions
- a. Advise client to open trust checking account
- b. Determine surviving spouse's cash needs for personal expenses
- c. Determine if administrative expenses already paid
- d. Give client list of administrative expenses
- 11. Discuss estate tax issues
- a. Determine if surviving spouse is a U.S. citizen
- b. Consider need to file Form 706 estate tax return
- c. Consider need for and timing of extension to file and/or pay tax
- d. Discuss alternate valuation
- e. Discuss special tax elections that might be available
- f. Review prior gifts
- (1) Determine if any gift tax returns ever filed
- (2) Determine if any gift tax returns required for unreported gifts
- (3) Determine if gift tax returns required to allocate GST exemption
- (4) Determine if gifts by an agent acting under a power of attorney were authorized

- (5) Determine if any gifts were made from the trust
- g. Identify assets includable although not otherwise inventoried
- h. Determine need for state estate tax returns in states other than state of domicile
- i. Consider GST issues
- j. Consider disclaimer planning
- (1) To reduce or eliminate marital gift to fully utilize unified credit
- (2) To create a marital deduction
- (3) To perfect or increase charitable deduction gift
- (4) To avoid general powers of appointment
- (5) To skip a generation
- (6) To qualify for stock redemption under IRC §303
- (7) To eliminate nonqualified heirs to qualify for IRC §2032A
- (8) To avoid multiple administrations and unnecessary estate taxes
- (9) To terminate a trust
- (10) To avoid income taxes
- (11) To accelerate estate tax to qualify for IRC §2013 prior transfer property (PTP) credit
- k. Transactions with irrevocable life insurance trust
- 12. Discuss income tax issues
- a. Allocate responsibility for decedent's personal returns and fiduciary returns
- b. Determine what returns need to be filed
- c. Explain basis step-up or step-down
- (1) Separate property of decedent spouse receives full adjustment
- (2) Separate property of surviving spouse receives no adjustment
- (3) Joint tenancy property receives partial adjustment
- (4) Community property receives full adjustment
- (5) Transmutations within 1 year of death
- (6) Joint tenancy property transferred directly to joint revocable trust
- d. Determine whether to use administrative trust
- e. Discuss income tax consequences of nonprorata allocation of community property
- f. Simple versus complex trusts
- g. Accumulation of income permitted
- h. Trust must report on calendar year basis
- i. Discuss income tax brackets for trusts
- j. Consider timing of distributions; 65-day rule
- k. Discuss need to issue IRS Forms 1099
- l. Personal exemption
- m. Quarterly estimates for trust
- n. S corporation
- o. Passive loss deduction
- p. Discuss income tax consequences of funding marital gift

- q. Discuss trust income during administration period
- r. Have client sign IRS Form SS-4 to obtain TIN for administrative trust
- 13. Discuss real property tax issues
- 14. Trustee compensation and time records
- 15. Preliminary liquidity analysis
- 16. Discuss fees, costs, retainer, and fee Agreement

C. Step Three: Actions Following First Meeting

- 1. New case set-up
- a. Set up new trust administration file
- b. Prepare and mail fee agreement
- c. Prepare joint representation agreement
- d. Apply for TIN if using administrative Trust
- 2. Calendar critical dates
- 3. Lodge pour-over will with county clerk and obtain certified copy
- 4. Prepare and send Medi-Cal notice
- 5. Prepare certification of trust and affidavit of death
- 6. Send disclaimer letter (disclaimer trust plan only)
- 7. Prepare and file change of ownership form
- 8. Collect asset and liability information
- a. Prepare preliminary inventory and mail to client with sample asset list
- b. Prepare and send letters to financial institutions
- c. Prepare and send letters to insurance companies
- d. Order deeds from title company for all real property
- e. Order appraisals for all parcels of real property
- f. Order appraisals for tangible personal property
- g. Order appraisals for intangible personal property
- h. Order appraisals for business interests
- i. Prepare and send letters regarding retirement benefits
- j. Enter data into spreadsheet and fiduciary accounting program
- 9. Prepare forms for creditor claim procedure
- 10. Record certification of trust in each county where real property located
- 11. Prepare and send IRS Form 4506 requesting copies of gift tax returns
- 12. Prepare and send information letter to beneficiaries
- 13. Prepare and send trust administration memorandum
- 14. Prepare letter of instructions to brokers
- 15. Deliver stock certificates to broker
- 16. Prepare CPA designation form
- 17. Communicate with out-of-state counsel for ancillary proceedings
- 18. Prepare and file parent-child exclusion application

- 19. Determine need to start court proceedings and prepare petitions
- 20. Prepare documents to collect nontrust assets
- 21. Corporate review and housekeeping for closely held corporations
- 22. Communicate with CPA

D. Step Four: Second Meeting with Client (and CPA)

- 1. Verify trust checking account established
- 2. Review client's record-keeping
- 3. Discuss progress on collection and appraisal of assets
- 4. Discuss possible sales of assets
- a. Determine need for liquidity
- b. Consider preference for cash versus in-kind distributions
- c. Review authority of trustee to sell
- d. Consider tax consequences of sale
- e. Discuss method of sale
- f. Watch for conflict of interest
- g. Consider obtaining court approval
- 5. Consider preliminary distributions
- a. Consider income tax effects
- b. Beware disproportionate preliminary distributions
- c. Consider liquidity needs, potential creditor claims and challenges to trust
- 6. Prepare and send letter to CPA confirming allocation of responsibilities

E. Step Five: Final Distribution

- 1. Finalize asset collection
- 2. Finalize fiduciary accounting schedules
- 3. Determine administration expenses incurred
- 4. Decide whether to take administration expenses on IRS Form 706 or 1041
- 5. Finalize and file IRS form 706/state estate tax returns
- 6. Draft final account and report of trustee
- 7. Determine if court approval of accounting appropriate
- 8. Consider income tax effects
- 9. Determine if any distributions carry earned income or interest
- 10. Determine amount of reserve
- 11. Determine amount of trustee's fee
- 12. Plan asset allocation among subtrusts
- a. Consider timing
- b. Consider prorata or Nonprorata
- c. Select allocation (distribution) date
- d. Obtain asset values and loan amounts as of allocation date
- e. Complete asset allocation spreadsheet

- f. Use segregated trusts or bookkeeping entries?
- g. Surviving spouse's income needs
- h. Appreciating assets
- i. Consider basis step-up at second death
- j. Family residence
- k. Vacation home
- l. Loans to children
- m. Assets subject to options or guaranties
- n. S corporation stock
- o. IRD items
- p. IRC §303 stock
- q. Retirement benefits
- r. Closely held business or nonproductive real estate
- s. Special use valuation property (IRC §2032A)
- t. Discount planning
- u. Unmatured life insurance
- v. Dividend reinvestment accounts

13. Prepare asset allocation agreement
14. Prepare written schedule of assets for ongoing trusts
15. Obtain TINs for ongoing trusts
16. Prepare certificates of trust for ongoing trusts
17. Prepare diagram of distribution
18. Send drafts of spreadsheet, asset schedules, and diagram to client and CPA
19. Consider review of distribution plan by beneficiaries
20. Consider court approval of distribution plan
21. Obtain trustee's and CPA's approval of distribution plan
22. Prepare transfer documents for funding distributions

- a. Written instructions to trustee regarding title to bank accounts
- b. Deeds, etc.
- c. Assumption of mortgages
- d. Assignments of lease
- e. Assignments of notes and deeds of trust
- f. Prepare and file UCC-2 statements
- g. Cancel old and issue new stock certificates for closely held corporations
- h. Assignments of partnership interests
- i. Assignments of unsecured promissory notes
- j. Letters to makers of notes advising of assignment
- k. Assignments of assets of sole proprietorship
- l. Assignments of personal property
- m. Forms to complete transfer of mobile homes

- n. Stock powers, affidavit of domicile, and letter of instructions for stock transfers
- o. Letters to transfer agents or deliver certificates to broker for transfer
- p. Letters of instructions to broker to transfer securities accounts
- q. Letters of instructions to mutual fund companies for transfer of accounts
- r. Transfer forms for treasury notes and bonds
- s. Letter and forms for transferring U.S. savings bonds
- t. Complete transfers of vehicles (cars, boats, airplanes)
- u. Miscellaneous assignments for other Assets

- 23. Prepare waivers of accounting if formal account required but not given
- 24. Prepare beneficiary receipts for outright distributions
- 25. Mail accounting, distribution checks/documents, and receipts by certified mail, if necessary
- 26. Prepare letter of instructions to client regarding administration of on-going trusts
- 27. Prepare letter to CPA regarding on-going trusts and allocation of responsibility for tax and accounting work
- 28. Send closing packet and termination of engagement letter to client
- 29. For a checklist for implementing subtrust allocation and funding and completion of administration for married person trusts that divide at the first death, see §14.83
- 30. Send client satisfaction survey form to client

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14A

Further Steps After the Death of the First Spouse

David B. Gaw
James P. Lamping

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§14A.1 I. AFTER INITIAL TRUST ADMINISTRATION

This chapter discusses further steps that may be considered by the surviving spouse and successor trustees after completion of the initial postmortem trust administration described in chap 14. These are steps to be taken during the lifetime of the surviving spouse (see §§14A.2-14A.9) or on the death of the survivor (see §§14A.10-14A.16) to enhance the favorable estate planning result achieved by subtrust funding on the first 'death. The chapter also discusses a number of issues that may arise when subtrust funding does not occur promptly on the first death. See §§14A.17-14A.25. For a general discussion of long-term trust administration, beginning with the initial consultation of the trustee with the attorney, see chap 17.

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II. DURING THE LIFETIME OF THE SURVIVING SPOUSE

§14A.2 A. Unitrust Conversion of Marital Trust

In appropriate circumstances, the trustee of the marital trust (usually the surviving spouse) should consider converting the trust into a unitrust. Assuming the marital trust is drafted as a QTIP trust under IRC §2056(b)(7), the trust provides that the survivor is entitled to all income of the trust property for life, payable annually or at more frequent intervals, with the right to compel the trustee to make the trust property productive of income. In many cases, this will require fairly elaborate trust accounting to allocate trust receipts and disbursements between principal and income under the complex rules contained in the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). See chap 8. There is also the potential for conflict between the surviving spouse and the remainder beneficiaries over investment policy, especially when the remainder beneficiaries are the children of the deceased spouse by a former marriage. The survivor generally will prefer income-producing assets (*i.e.,* bonds) that will maximize the benefit to the survivor, and the remainder beneficiaries will prefer growth assets (*i.e.,* stocks) that will maximize the amount remaining in the trust on the death of the survivor.

These problems often can be avoided by converting the marital trust into a unitrust with a payout percentage between 3 and 5 percent of the net fair market value of trust assets per year in satisfaction of the survivor's right to a qualifying income interest for life. Treas Reg §§1.643(b)-1, 20.2056(b)-7(d)(1). See §14A.3.

NOTE: In IRS Letter Ruling 200702013, the IRS ruled that unitrust conversions of a credit shelter trust and a reverse-QTIP-election trust would not result in the loss of generation-skipping transfer (GST) tax zero inclusion ratios. Both trusts were exempt from GST tax as a consequence of receiving allocations of the deceased settlor's GST exemption in amounts that resulted in the trusts having inclusion ratios of zero.

Alternatively, the trustee of the marital trust may use the Prob C §16336 adjustment power to allocate a portion of trust principal to income, somewhat simplifying the accounting and allowing the survivor to benefit from the growth of trust assets. However, the adjustment power cannot be used if the survivor is the trustee, as is usually the case, because the survivor is a beneficiary of the trust. Prob C §16336(b)(7). See §7.35.

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§14A.3 1. Unitrust Conversion Procedure

Under the unitrust conversion procedure in Prob C §§16336.4-16336.6, the trustee can convert the trust into a unitrust with a payout percentage of 4 percent per year without court approval if no beneficiary objects in writing to the conversion on notice of proposed action under Prob C §§16500-16504; the trustee can convert the trust into a unitrust with a greater or lesser percentage between 3 and 5 percent if all beneficiaries consent in writing. Prob C §§16336.4, 16336.5(a). For a form of notice of proposed action that can be used to seek consent to a unitrust conversion, see §14A.4.

If any beneficiary objects or does not consent to the conversion, the trustee may petition for court approval. The court may order the conversion if the court concludes that the conversion will better enable the trustee to satisfy the requirement of impartiality in administration of the trust. Prob C §16336.5(b). In *Matter of Heller* (2006) 816 NYS2d 403, 849 NE2d 262, successor trustees of a testamentary trust converted a net income trust funded with high-yield investments into a unitrust with a payout percentage of 4 percent, which reduced the average annual income paid to the surviving spouse from $190,000 to $70,000; the court upheld the conversion. Court approval of the conversion also may be appropriate if a petition is already considered necessary for approval of other trustee actions, such as payment of compensation or rendering of accounts if otherwise required. For a form of court petition for approval of a unitrust conversion and memorandum in support that may be adapted to a unitrust conversion of the marital trust, see §14A.5.

Payment of a unitrust amount in satisfaction of a right to income generally requires annual valuation of trust assets. Prob C §16336.4(e)(4). For trusts consisting largely of brokerage accounts, valuation of trust assets should be relatively simple. Note that residential property or tangible personal property used in kind by the surviving settlor satisfies the right to income with respect to the property and is therefore excluded from the calculation of the unitrust amount. Prob C §16336.4(e)(4)(A). This avoids both the need to value the property and the need to pay rent to the trust (which may have income tax consequences) to satisfy the trustee's fiduciary duty to the remainder beneficiaries with respect to the property. For trusts with other hard-to-value assets, however, the annual valuation may be more difficult than traditional trust accounting.

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Source: Estate Planning/California Trust Administration/14A Further Steps After the Death of the First Spouse/§14A.4 2. Form: Notice of Proposed Action (Prob C §§16500-16504)

§14A.4 2. Form: Notice of Proposed Action (Prob C §§16500-16504)

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NOTICE OF PROPOSED ACTION

Probate Code §16500 et seq.

TO THE BENEFICIARIES OF THE _ _[*NAME*]_ _ TRUST

Pursuant to Probate Code §§16500-16504, the trustee hereby gives notice to all beneficiaries of the above referenced trust that s/he intends to take the following proposed action:

On or after _ _[*date*]_ _, the trustee will take the following action: Convert the trust to a unitrust pursuant to Probate Code §§16336.4-16336.6. _ _[*Description of converted unitrust.*]_ _

¨ See attachment for additional details (check if applicable)

NOTICE

THIS NOTICE IS BEING GIVEN PURSUANT TO PROBATE CODE SECTION 16502. If you do not object in writing or obtain a court order preventing the action described above, you will be treated as if you consented to the proposed action and you may not object after the proposed action is taken. If the trustee receives a written objection within the applicable period, either the trustee or a beneficiary may petition the court to have the proposed action taken as proposed, taken with modifications, or denied. Probate Code §16501(d) lists certain actions for which this notice <u>may not</u> be used.

1. The name and address of the trustee:

Name _ _[*name*]_ _

Address _ _[*address*]_ _

2. If you need additional information concerning the proposed action, please contact:

Name _ _[*name*]_ _

Address _ _[*address*]_ _

Telephone _ _[*telephone*]_ _

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Attorney for*]_ _ **Trustee**

3. IF YOU OBJECT OR CONSENT TO THE TRANSACTION, YOU MAY INDICATE YOUR OBJECTION OR CONSENT BY SIGNING AND RETURNING THIS FORM TO THE TRUSTEE AT THE ADDRESS LISTED IN ITEM 1 ABOVE NO LATER THAN _ _[*date*]_ _.

YOU MAY SEND YOUR OWN WRITTEN OBJECTION OR CONSENT. BE SURE TO IDENTIFY THE PROPOSED ACTION AND STATE THAT YOU OBJECT OR CONSENT TO IT.

OBJECTION TO PROPOSED ACTION

¨ **I OBJECT to the proposed action described above.**

Date: _ _ _ _ _ _ __[*Signature of objector*]__
_ _[*Typed name*]_ _
_ _[*Address*]_ _
_ _[*Telephone*]_ _

CONSENT TO PROPOSED ACTION

¨ **I CONSENT to the proposed action described above.**

Notice: You may indicate your consent by signing and returning this form (both pages) to the trustee at the address in item 1. If you do not object or obtain a court order before the date specified above, you will be treated as if you consented to the proposed action.

Date: _ _ _ _ _ _ __[*Signature of consentor*]__
_ _[*Typed name*]_ _
_ _[*Address*]_ _
_ _[*Telephone*]_ _

Comment: The attachment may describe the terms of the proposed unitrust conversion. For a preprinted notice and consent form for a notice of proposed action under Prob C §§16500-16504 similar to the Notice of Proposed Action—Independent Administration of Estates Act (Judicial Council Form DE-165), see the members-only page of the Trusts and Estates Section of the State Bar of California at http://www.calbar.org.

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§14A.5 3. Form: Sample Prob C §17200 Petition and Memorandum in Support

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Attorneys for MARY M. RICH, Trustee

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF NAPA

In re the Matter of:	)	**Case No.: _ _ _ _ _ _**
RICHARD RICH, SR. INTER	)	
VIVOS IRREVOCABLE TRUST	)	**PETITION TO APPROVE**
UTD 11/26/37 FBO RICHARD	)	**FIRST, SECOND, AND THIRD**
RICH, JR.	)	**ACCOUNT AND REPORT,**
	)	**FOR APPROVAL OF**
	)	**TRUSTEE'S AND ATTORNEY**
	)	**FEES, AND FOR**
	)	**MODIFICATION OF TRUST,**
	)	**AND FOR APPROVAL OF**
	)	**TRUSTEE'S INVESTMENT**
	)	**PLAN (PROBATE CODE**
	)	**§§1060, 15409, 15411, 16063,**
	)	**and 17200(b))**
	)	**Hearing Date: _ _**[*date*]**_ _**
	)	**Time: _ _**[*time*]**_ _**
	)	**Dep't: _ _**[*number*]**_ _**
_____)		

MARY M. RICH, as Trustee of The Richard Rich, Sr. Inter Vivos Irrevocable Trust UTD 11/26/37 FBO Richard Rich, Jr. ("the Trust"), presents the following Petition to Approve First, Second, and Third Account and Report, for Approval of Trustee's and Attorney Fees, for Modification of Trust, and for Approval of Trustee's Investment Plan, for the periods of November 19, 2001, through September 17, 2002, September 18, 2002, through September 30, 2003, and October 1, 2003, through July 31, 2004, for approval, pursuant to California Probate Code Sections 1060, 15409, 15411, 16063, and 17200(b):

1. Summary of Trust. The Trust was established by Richard Rich by Trust Agreement dated November 26, 1937. On November 19, 2001, by Stipulation and Order on file herein, Mary M. Rich was appointed Temporary Trustee of the Trust. Since that time, the Temporary Trustee has been the authorized and acting Trustee of the Trust. The Trust provides, in pertinent part, for distribution of the Trust Estate, at page 3, as follows:

> **1. The beneficiary of this Trust shall be RICHARD RICH, JR., son of the Trustor, and the Trustee shall collect the income from the Trust estate and pay therefrom, or if that be insufficient then from the principal of the Trust estate, all taxes, assessments, or other charges and expenses against the Trust estate or arising in connection with the administration of this Trust, including the compensation the Trustee may have obtained for the use and benefit of the Trust estate; and the Trustee shall pay the net income in quarterly installments of equal amount,**

or as nearly equal as possible, to RICHARD RICH, JR.

2. This Trust shall cease and terminate upon the death of the said RICHARD RICH, JR. and thereupon the Trustee shall pay, distribute, and convey the Trust estate then remaining in its hands, together with any accrued or accumulated and undistributed income thereof, as follows:

(a) If the said son of the Trustor leaves issue, then alive, then to such issue per stirpes; provided, however, that if either MIRELLA RICH, wife of the Trustor, or the Trustor, be then surviving the Trustee shall appraise the corpus of the Trust fund and estate upon the basis of its market value as of the date of death of the said RICHARD RICH, JR. and shall pay, deliver, and convey to the issue of the said son of the Trustor only so much of the Trust fund and estate as shall be equal in market value to FIFTY THOUSAND DOLLARS ($50,000). The excess of the Trust fund and estate of FIFTY THOUSAND DOLLARS ($50,000) in market value as of the date of death of the said son of the Trustor shall be paid, delivered, and conveyed by the Trustee of this Trust to MIRELLA RICH, wife of the Trustor, in the event that she then survives, or if she be deceased, to the Trustor. The determination of the Trustee as to market value of the Trust fund and estate shall be binding and conclusive upon all the persons interested hereunder.

(b) If the said son of the Trustor leaves no issue then alive, the Trustee shall pay, deliver, and convey the Trust fund and estate then in its hands to the said MIRELLA RICH, wife of Trustor, or if she be deceased, then to the Trustor.

(c) If the said son of the Trustor shall leave no issue then surviving and if the said MIRELLA RICH and the Trustor both predecease the said son, the Trust estate shall be divided into equal parts, one for each child of the Trustor then surviving and one for each child of the Trustor deceased but leaving issue then surviving. The equal part for the issue of any deceased child shall be paid, delivered, and conveyed by the said Trustee of this Trust to such issue per stirpes. The equal part for each child of the Trustor then living shall be paid, delivered, and conveyed by the Trustee of this Trust to the then Trustee of that certain Trust created on the 26th day of November, 1937, with BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION as Trustee for the use and benefit of such child to be and become a part of the corpus of said Trust and subject to all the trusts therein set forth.

In the event that there should be a child of the Trustor other than the children of the Trustor hereinafter referred to, then the said equal part for such after-born child shall be paid, delivered, and conveyed by the Trustee of this Trust to such child free and clear of any trust.

(d) If at the time of the death of the said RICHARD RICH, JR. he shall have no issue then surviving, and if the said MIRELLA RICH and the Trustor are both dead and there are no children of the Trustor then alive, or issue of any deceased child of the Trustor, then the Trustee of this Trust shall pay, distribute, and convey the Trust estate to the heirs at law of the Trustor as determined by the laws of the State of California pertaining to intestate succession as they exist upon the date of death of the Trustor in relation to separate property. The determination of the heirs at law of the said Trustor shall be made by the Trustee of this Trust and such determination shall be binding and conclusive upon all persons no matter how interested herein.

(e) The Trustor hereby declares that at the date of execution of this Agreement there is no child of his deceased leaving issue and that he has living only two (2) children whose names and dates of birth are as follows:

RICHARD RICH, JR., born July 25, 1918.

MAUREEN RICH, born August 21, 1920.

The Trustee is authorized in its sole discretion, upon division or distribution of the Trust estate or any part thereof to make such division or distribution in kind, or partly in kind and partly in money, and its determination of values of the property for such division or distribution shall be binding and conclusive.

2. Status of Trust Administration. The Trustee has collected all assets belonging to the Trust, will file all fiduciary income tax returns for the Trust that will become due, and has paid the debts, taxes, and expenses of Trust administration that have become due, with the exception of the Trustee and attorney fees. By its terms, the Trust is not now in a condition to be terminated, nor the assets distributed.

3. Summary of Account. Three Summaries of Account are attached hereto, as Exhibit A, Exhibit B, and Exhibit C, respectively. Exhibit A is the First Account covering the period of November 19, 2001, through September 17, 2002. Exhibit B is the Second Account covering the period from September 18, 2002, through September 30, 2003. Exhibit C is the Third Account covering the period from October 1, 2003, through July 31, 2004. The Summary of Account is divided into separate accounts because the first account and report covers the date of settlement to September 17, 2002 (Stipulation and Order filed November 19, 2001), and the second account and report covers the following 12-month period. The third account and report brings the accounting current for the last 10 months. The Summary of Account is a recapitulation of the various, *e.g.,* schedules of receipts and disbursements, as required by Probate Code section 1060 et seq.

FIRST ACCOUNTING PERIOD

4. Trust Estate on Hand at Commencement of First Accounting Period. The total Trust estate on hand as of November 19, 2001, the commencement of the accounting period covered by this account and report, consisted of assets with a value of $1,606,827.24, as set forth in Schedule A, Exhibit A. Schedule A contains all of the assets of the Trust as of the date of appointment of the Successor Trustee pursuant to order of this Court filed November 19, 2001.

5. Additional Property Received. During the period covered by this account and report, the Successor Trustee reports additional property received by the Trust of $300.00, as set forth in Schedule B, Exhibit A.

6. Income and Principal Receipts. During the period covered by this account and report, the Trustee reports income receipts of $96,947.09, as set forth in Schedule C, Exhibit A.

7. Gains on Sales or Other Dispositions. During the period covered by this account and report, the Trustee reports no gains on sales or other dispositions (Schedule D, Exhibit A).

8. Net Income From Trade or Business. During the period covered by this account and report, the Trustee reports no net income from trade or business (Schedule E, Exhibit A).

9. Disbursements. During the period covered by this account and report, the Trustee made principal disbursements of $19,898.42 and income disbursements of $70,559.55, for a total of disbursements of $90,498.37, as set forth in Schedule F, Exhibit A.

10. Losses on Sales or Other Dispositions. During the period covered by this account and report, the Trustee reports no losses on sales or other dispositions (Schedule G, Exhibit A).

11. Net Loss from Trade or Business. During the period covered by this account and report, the Trustee reports no net loss from trade or business (Schedule H, Exhibit A).

12. Distributions to Beneficiaries. During the period covered by this account and report, the Trustee made no distributions to the Trust beneficiary (Schedule I, Exhibit A).

13. Trust Estate on Hand at End of First Accounting Period. The total Trust estate on hand as of September 17, 2002, the end of the first accounting period, is comprised of assets having a total value of $1,613,575.96, as described on Schedule J, Exhibit A. Noncash assets are shown at their carry value.

14. Estimated Fair Market Value at the Beginning of Accounting Period. The Trustee estimates that the fair market value of the noncash assets of the Trust at the beginning of the first accounting period is as shown on Schedule K, Exhibit A.

15. Trust Liabilities at End of Accounting Period. The Trustee reports no Trust liabilities as of September 17, 2002, the end of the first accounting period (Schedule L, Exhibit A).

16. Additional Schedules. Additional Schedules M through R, listed as Additional Supporting Schedules following the Summary of Account, are either attached hereto as required by Probate Code section 1063 and are self-explanatory, or are not applicable and therefore are not included in this account.

SECOND ACCOUNTING PERIOD

17. Trust Estate on Hand at Commencement of Second Accounting Period. The total Trust Estate on hand as of September 18, 2002, the commencement of the accounting period covered by this account and report, consisted of assets with a value of $1,613,575.96, as set forth in Schedule A, Exhibit B. Schedule A contains all of the assets of the Trust from September 18, 2002, through September 30, 2003.

18. Additional Property Received. During the period covered by this account and report, the Successor Trustee reports additional property received by the Trust of $1,500,000.00, as set forth in Schedule B, Exhibit B.

19. Income and Principal Receipts. During the period covered by this account and report, the Trustee reports

income receipts of $120,464.21, as set forth in Schedule C, Exhibit B.

20. Gains on Sales or Other Dispositions. During the period covered by this account and report, the Trustee reports no gains on sales or other dispositions (Schedule D, Exhibit B).

21. Net Income From Trade or Business. During the period covered by this account and report, the Trustee reports no net income from trade or business (Schedule E, Exhibit B).

22. Disbursements. During the period covered by this account and report, the Trustee made principal disbursements of $490,604.36 and income disbursements of $97,814.08, for a total of disbursements of $588,418.44, as set forth in Schedule F, Exhibit B.

23. Losses on Sales or Other Dispositions. During the period covered by this account and report, the Trustee reports no losses on sales or other dispositions (Schedule G, Exhibit B).

24. Net Loss From Trade or Business. During the period covered by this account and report, the Trustee reports no net loss from trade or business (Schedule H, Exhibit B).

25. Distributions to Trust Beneficiary. During the period covered by this account and report, the Trustee made distributions to the Trust beneficiary in the amount of $28,156.77, as set forth in Schedule I, Exhibit B.

26. Trust Estate on Hand at End of Accounting Period. The total Trust estate on hand as of September 30, 2003, the end of the second accounting period, is comprised of assets having a total value of $2,617,464.96, as described on Schedule J, Exhibit B. Noncash assets are shown at their carry value.

27. Estimated Fair Market Value at the Beginning of Accounting Period. The Trustee estimates that the fair market value of the noncash assets of the Trust at the beginning of the second accounting period is as shown on Schedule K, Exhibit B.

28. Trust Liabilities at End of Accounting Period. The Trustee reports Trust liabilities in the amount of $500,000 as of September 30, 2003, the end of the second accounting period, as described in Schedule L, Exhibit B.

29. Additional Schedules. Additional Schedules M through R, listed as Additional Supporting Schedules following the Summary of Account, are either attached hereto as required by Probate Code section 1063 and are self-explanatory, or are not applicable and therefore are not included in this account.

THIRD ACCOUNTING PERIOD

30. Trust Estate on Hand at Commencement of Third Accounting Period. The total Trust Estate on hand as of October 1, 2003, the commencement of the accounting period covered by this account and report, consisted of assets with a value of $2,617,464.96, as set forth in Schedule A, Exhibit C. Schedule A contains all of the assets of the Trust from October 1, 2003, through July 31, 2004.

31. Additional Property Received. During the period covered by this account and report, the Successor Trustee reports no additional property received (Schedule B, Exhibit C).

32. Income and Principal Receipts. During the period covered by this account and report, the Trustee reports income receipts of $205,194.10, as set forth in Schedule C, Exhibit C.

33. Gains on Sales or Other Dispositions. During the period covered by this account and report, the Trustee reports no gains on sales or other dispositions (Schedule D, Exhibit C).

34. Net Income From Trade or Business. During the period covered by this account and report, the Trustee reports no net income from trade or business (Schedule E, Exhibit C).

35. Disbursements. During the period covered by this account and report, the Trustee made principal disbursements of $69,568.72 and income disbursements of $81,753.22, for a total of disbursements of $151,321.94, as set forth in Schedule F, Exhibit C.

36. Losses on Sales or Other Dispositions. During the period covered by this account and report, the Trustee reports losses on sales or other dispositions in the amount of $10,000, as set forth in Schedule G, Exhibit C.

37. Net Loss From Trade or Business. During the period covered by this account and report, the Trustee reports no net loss from trade or business (Schedule H, Exhibit C).

38. Distributions to Trust Beneficiary. During the period covered by this account and report, the Trustee made distributions to the Trust beneficiary in the amount of $11,099.15, as set forth in Schedule I, Exhibit C.

39. Trust Estate on Hand at End of Accounting Period. The total Trust estate on hand as of July 31, 2004, the end of the third accounting period, is comprised of assets having a total value of $2,650,237.97, as described on Schedule J, Exhibit C. Noncash assets are shown at their carry value.

40. Estimated Fair Market Value at the Beginning of Accounting Period. The Trustee estimates that the fair market value of the noncash assets of the Trust at the beginning of the third accounting period is as shown on Schedule K, Exhibit C.

41. Trust Liabilities at End of Accounting Period. The Trustee reports Trust liabilities in the amount of $500,000 as of July 30, 2004, the end of the third accounting period, as described in Schedule L, Exhibit C.

42. Additional Schedules. Additional Schedules M through R, listed as Additional Supporting Schedules following the Summary of Account, are either attached hereto as required by Probate Code §1063 and are self-explanatory, or are not applicable and therefore are not included in this account.

43. Proposed Distribution. The Trustee reports that proposed total distribution of excess net income to Richard Rich, Jr. of $24,826.24, as indicated on Schedule Q.

44. Estimated Fair Market Value of Property on Hand at the End of the Accounting Period. As indicated on Schedule R, the Fair Market Value of the Property on Hand at the end of the third accounting period is $2,865,237.97.

TRUSTEE'S COMPENSATION

45. During the first accounting period, the Trustee received compensation in the amount of $13,405.62. This amount represents approximately 1 percent of the estate value over a 10-month period based on the beginning balance of the first accounting period. During the second accounting period, the Trustee received compensation in the amount of $15,458.11. As per the stipulation, the Trustee was to receive 1 percent of the estate value prior to the settlement date and 3/4 percent of the estate value thereafter. The $15,458.11 is in excess of 3/4 percent of the beginning balance because the $1,000,000 Note and Deed of Trust was included in the base fee amount, but it should have been included in the third account and report period. To compensate for this, the Trustee fees for the next accounting period were reduced accordingly. Attached hereto as Exhibit D is a spreadsheet that details the payments to the Trustee for the first, second, and third accounting periods. The Note and Deed of Trust technically became an asset of the Trust estate when the settlement agreement was executed; however, since interest did not begin to accrue until January 2003, the Trustee decided not to include the $1,000,000 in the beginning balance, thus saving the Trust approximately $2200 in Trustee fees.

COMPENSATION OF AGENTS

46. During the period covered by this account and report, the Trustee hired certain agents to assist her in carrying out her responsibilities in administering the Trust. During such period, Petitioner paid the following amounts to those agents:

First Accounting Period:

P&B Smith, CPA (accounting fees):	**$1546.00**	
Gaw, Van Male, Smith, Myers & Reynolds (attorney fees):		**$6570.50**

Second Accounting Period:

P&B Smith, CPA (accounting fees): $657.50

Gaw, Van Male, Smith, Myers & Reynolds (attorney fees): $3000.00

Third Accounting Period:

P&B Smith, CPA (accounting fees): $350.00

Gaw, Van Male, Smith, Myers & Reynolds (attorney fees): $2400.00

None of the agents is related to or affiliated with the Trustee.

PERSONS INTERESTED IN THE TRUST

47. The names and addresses of all persons interested in the Trust who are to receive a copy of this account and report are as follows:

Income Beneficiary:

Richard Rich, Jr., 123 California Drive, Napa, CA 94558

Richard Rich, Jr., c/o Bob Jones, Jones, Smith & Jones, 157 Attorney Street, Napa, CA 94558

Remainder Beneficiaries:

Maureen Rich, 147 South Tree Drive, Orange, CA 92869

Richard Rich, Jr., 123 California Drive, Napa, CA 94558

MODIFICATION OF TRUST

48. The Trust to be established for the lifetime benefit of RICHARD RICH, JR., son of Trustor, under the terms of The Richard Rich, Sr. Inter Vivos Irrevocable Trust UTD 11/26/37 FBO Richard Rich, Jr., provides as follows regarding distribution of net Trust accounting income during the beneficiary's lifetime, at page 3, in paragraph 1, of the Trust:

> **1. The beneficiary of this Trust shall be RICHARD RICH, JR., son of the Trustor, and the Trustee shall collect the income from the Trust estate and pay therefrom, or if that be insufficient then from the principal of the Trust estate, all taxes, assessments, or other charges and expenses against the Trust estate or arising in connection with the administration of this Trust, including the compensation the Trustee may have obtained for the use and benefit of the Trust estate; and the Trustee shall pay the *net income* in *quarterly* installments of equal amount, or as nearly equal as possible, to RICHARD RICH, JR.**

Petitioner seeks to modify the foregoing terms by substituting a "unitrust amount" in place of the "net income" amount. A "unitrust amount," as described, is a percentage of the assets of the Trust estate valued at regular intervals, typically annually, and paid periodically. The Petitioner also requests that the Trust be modified to allow for a *monthly* payout to the income beneficiary rather than quarterly.

The reason that the Petitioner requests modification of the Trust is that the Trust should address a total investment strategy. A "unitrust" is a trust that provides the beneficiary with a right to periodically receive a fixed percentage of the net value of the trust estate with the assets revalued at selected intervals. A unitrust also allows for investments to be made in growth or equity positions that typically benefit the income beneficiary. It also provides for principal to be increased, which benefits the remainder beneficiaries. A unitrust benefits both the income beneficiary and the remainder beneficiary.

The traditional trust investment strategy does not consider the value of money over time. If a trust has been in effect a long period of time, as the present Trust has, the value of the principal, in real terms, has less purchasing power due to inflation. The purchasing power of a dollar in 1937 was much greater than it is today. A unitrust investment strategy would allow for an increase in principal while allowing for an allocation of predictable income.

Trustees have a fiduciary duty, under state trust law, to balance the interests of the income beneficiary (who wants to maximize income and will, therefore, prefer fixed-income investments, *i.e.,* bonds) with the interests of the remainder beneficiaries (who want to maximize growth and will, therefore, prefer equity investments, *i.e.,* stocks). The trustee is often placed in a compromising position that is difficult to justify to the income beneficiary, as well as the remainder beneficiary. The unitrust concept does not place the trustee at odds with the income beneficiary or the remainder beneficiaries. A unitrust allows for the income beneficiary to be assured of a predictable income each year. A unitrust provides for the possibility that the principal will grow, which benefits the remainder beneficiaries.

Petitioner is informed and believes, and thereon alleges, that due to circumstances *not* known to the Trustor and not anticipated by Trustor in 1937, the continuation of the Trust under its present terms would defeat or substantially impair the accomplishment of the purposes of the Trust, and that it is necessary that this Court authorize the proposed modification of the Trust.

Petitioner is informed and believes, and thereon alleges, that the Trustor's intended purpose of the Trust was twofold: (1) to provide for a reasonable income stream to the current beneficiary (Trustor's child); and (2) to preserve the purchasing power of the corpus of the Trust for ultimate distribution to the descendants of the Trustor's issue.

The changed circumstances referred to above, which were not known to Trustor and which could not have been anticipated by Trustor when the Trust was executed in 1937, consist of the adoption by the California Legislature of (1) the Uniform Prudent Investor Act (California Probate Code §§16045-16054, effective January 1, 1996), and (2) the Uniform Principal and Income Act (California Probate Code §§16320-16375, effective January 1, 2000), both of which apply to all trusts in existence on the date of enactment, including this Trust. In addition, the Trustor could not have predicted the variations in the real estate market or the stock and bond markets. The unitrust allows for a more flexible investment strategy by the Trustee.

Due to the changed circumstances in the Trust Law, Petitioner is informed and believes, and thereon alleges, that the Trust should be modified to delete the provisions requiring Trustee to distribute net income in quarterly installments of equal amounts, to be replaced with a provision requiring the Trustee to distribute *annually* to the beneficiary in monthly installments, a unitrust amount equal to five percent of the net value of the Trust. Such modification would eliminate paragraph 1, "Trustee shall pay the net income in quarterly installments of equal amounts," and replace it as follows:

> **Trustee shall in each calendar year during the lifetime of the income beneficiary, provided such beneficiary is living on the distribution date, pay to or apply for the benefit of the current beneficiary, in monthly installments, an amount equal to five percent (5%) of the fair market value, less debt, of the beneficiary's Trust as of the close of business on the last business day of July each calendar year, *i.e.,* the distribution date. All computations of fair market value shall include Trust accounting income and principal, but no accruals shall be required. If the beneficiary's Trust includes assets for which there is not a ready market, the Trustee shall adopt such method of valuation as the Trustee deems reasonable in its discretion under the circumstances. The distribution amounts paid from time to time shall be paid first from net Trust accounting income, next from net realized short-term capital gains, then from net realized long-term capital gains, and then only if necessary from the principal of the beneficiary's Trust.**

If the Court approves the proposed modification of the Trust, Petitioner will distribute forthwith to the income beneficiary all excess accrued income through the end of the third accounting period of $24,826.24, as itemized in Schedule Q.

Petitioner will begin to pay the 5 percent unitrust amount in monthly installments of $9,900.46, calculated as follows: The net value of the Trust as shown on Schedule R of the third account, less the mortgage amount, *i.e.,* $2,865,237.97 − $489,128.00 = $2,376,109.97 (net value of Trust assets); $2,376,109.97 × 0.05 = $118,805.50 per year (annual unitrust payout to income beneficiary); $118,505.50 divided by 12 months = $9900.46 per month (monthly payout installments to income beneficiary). Monthly payout installments will begin the first of the month after the Court approves this request and grants the Petition in this matter.

INVESTMENT PLAN

49. Petition for Approval to Invest Estate Assets. Petitioner requests approval of an investment plan. As set forth, the Trust estate currently consists of assets of real property located in San Francisco, as well as the

proceeds of a promissory note in the amount of $1,000,000. The note was recently paid to the Trust estate, thereby necessitating an investment plan. The income beneficiary's and the remainder beneficiaries' divergent interests are addressed by the Trustee in a fair, prudent, and reasonable way in the proposed investment plan. By making investments pursuant to modern portfolio theory, Petitioner hopes to increase the overall estate assets without exposing the estate to an inordinate amount of risk and provide for potential growth of these assets.

Petitioner's investment plan is to keep the real property, *i.e.,* an apartment building, as an income producing asset, in addition to the potential growth in equity. The real property has generated $313,729.96 from December 2001 to July 2004. This is an annual effective rental income of $117,648.74 per year. See Exhibit E for the Calculation of the Internal Rate of Return on the Real Property. As indicated in Exhibit E, the estimated sales price of the real property is $1,750,000 (estimated $1,700,000-1,800,000). The cost of sale would be approximately 7 percent. The mortgage payoff would be $489,128.00. The internal rate of return over the first, second, and third accounting periods has been 5.8 percent. See the calculation in Exhibit E. If the real property is sold, there would be net proceeds of the sale of $1,138,372 after the cost of sale and payment of the loan. That amount if reinvested would have to earn a 9 percent return on investment to equal the current return of 5.8 percent. Therefore, unless and until all beneficiaries (income and remainderman) agree in writing to sell the apartment building or until a Probate Code section 17200 petition results in a court order to sell the apartment building, the Trustee will retain said property.

Petitioner plans to invest the proceeds of the $1,000,000 note according to an investment plan of 60 percent growth equities, *i.e.,* stocks, 35 percent bonds, and 5 percent cash. Petitioner is working in cooperation with a qualified financial planner. This balanced portfolio will allow the income beneficiary to receive a fixed, ascertainable amount of income on a regular basis and the remainder beneficiaries will benefit by the prospect of potential growth to principal if the overall income exceeds 5 percent per year. Thus, the modification of the Trust to a "unitrust" and the approval of the proposed investment plan are in the best interests of the income beneficiary and the remainder beneficiaries.

WHEREFORE, Petitioner requests this Court to order:

1. Approving and settling Petitioner's first, second, and third accounting of her administration of the Trust as reported herein;

2. Approving the payment of net income accrued but not paid to the income beneficiary, RICHARD RICH JR.;

3. Ratifying, confirming, and approving all acts of Petitioner as reported herein and approving Trustee's fees;

4. Approving the modification of the Trust to a 5 percent unitrust for the benefit of the income beneficiary and the remainder beneficiaries;

5. Approving the distribution of the 5 percent unitrust amount based on the net value of the Trust as of the end of the third accounting period and recalculated on the value of the Trust on an annual basis thereafter;

6. Approving monthly payout of net Trust income to the income beneficiary;

7. Approving the compensation paid by Petitioner to her attorneys and accountants for services rendered during the period of this account and report;

8. Approving the Trustee's investment plan; and

9. For such other orders as the Court considers necessary, proper, or just.

Date: _ _ _ _ _ _

__[*Signature*]__
MARY M. RICH, Trustee of The Richard Rich, Sr. Inter Vivos Irrevocable Trust UTD 11/26/37 FBO Richard Rich, Jr.

GAW, VAN MALE, SMITH, MYERS & REYNOLDS

By: __[*Signature*]__
JAMES P. LAMPING

Attorneys for Trustee

VERIFICATION

I, MARY M. RICH, have read the foregoing Petition and know the contents thereof; I certify that the same is true of my own knowledge, except as to the matters therein stated on information and belief, and as to those matters, I believe them to be true.

I further declare that the foregoing first and final account is in all respects true and correct and contains a full, true, and particular account of all receipts and disbursements on account of the Trust estate and of all sums of money or property belonging to the estate which may come into my possession as Trustee or which have been received by any other persons by my order or authority for the use of the Trust estate. I do not know of any error or omission in the account to the prejudice of any person interested in the estate.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed on _ _[*date*]_ _ at Napa, California.

__[*Signature*]__
MARY M. RICH
Petitioner

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SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF NAPA

In re RICHARD RICH, SR.	**)**	**Case No.: _ _ _ _ _ _**
INTER VIVOS IRREVOCABLE	**)**	**MEMORANDUM IN SUPPORT**
TRUST UTD 11/26/37 FBO	**)**	**OF PETITION FOR**
RICHARD RICH, JR.	**)**	**MODIFICATION OF TRUST**
	)	**(PROBATE CODE §15409)**
	)	**Hearing Date: _ _[*date*]_ _**
	)	**Time: _ _[*time*]_ _**
_____)		**Dep't: _ _[*number*]_ _**

MARY M. RICH, as Trustee of The Richard Rich, Sr. Inter Vivos Irrevocable Trust UTD 11/26/37 FBO Richard Rich, Jr. ("the Trust"), submits the following Memorandum in Support of her Petition for Modification of Trust filed herein:

I. FACTS

The Trust was established by Richard Rich by Trust Agreement dated November 26, 1937. On November 19, 2001, by Stipulation and Order on file herein, Mary M. Rich was appointed Temporary Trustee of the Trust. Since that time, the Temporary Trustee has been the authorized and acting Trustee of the Trust. The Trust provides for distribution of the Trust estate, at page 3, in relevant part, as follows:

> **1. The beneficiary of this Trust shall be RICHARD RICH, JR., son of the Trustor, and the Trustee shall collect the income from the Trust estate and pay therefrom, or if that be insufficient then from the principal of the Trust estate, all taxes, assessments, or other charges and expenses against the Trust estate or arising in connection**

with the administration of this Trust, including the compensation the Trustee may have obtained for the use and benefit of the Trust estate; and the Trustee shall pay the net income in quarterly installments of equal amount, or as nearly equal as possible, to RICHARD RICH, JR.

2. This Trust shall cease and terminate upon the death of the said RICHARD RICH, JR. and thereupon the Trustee shall pay, distribute, and convey the Trust estate then remaining in its hands, together with any accrued or accumulated and undistributed income thereof, as follows:

(a) If the said son of the Trustor leaves issue, then alive, then to such issue per stirpes….

(b) If the said son of the Trustor leaves no issue then alive, the Trustee shall pay, deliver, and convey the Trust fund and estate then in its hands to the said MIRELLA RICH, wife of Trustor, or if she be deceased, then to the Trustor.

(c) If the said son of the Trustor shall leave no issue then surviving and if the said MIRELLA RICH and the Trustor both predecease the said son, the Trust estate shall be divided into equal parts, one for each child of the Trustor then surviving and one for each child of the Trustor deceased but leaving issue then surviving….

(d) If at the time of the death of the said RICHARD RICH, JR. he shall have no issue then surviving, and if the said MIRELLA RICH and the Trustor are both dead and there are no children of the Trustor then alive, or issue of any deceased child of the Trustor, then the Trustee of this Trust shall pay, distribute, and convey the Trust estate to the heirs at law of the Trustor….

(e) The Trustor hereby declares that at the date of execution of this Agreement there is no child of his deceased leaving issue and that he has living only two (2) children whose names and dates of birth are as follows:

RICHARD RICH, JR., born July 25, 1918.

MAUREEN RICH, born August 21, 1920.

The Trustee is authorized in its sole discretion, upon division or distribution of the Trust estate or any part thereof to make such division or distribution in kind, or partly in kind and partly in money, and its determination of values of the property for such division or distribution shall be binding and conclusive.

The income beneficiary of the Trust is Richard Rich, Jr. and the remainder beneficiaries are Maureen Rich and the children of Richard Rich, Jr.

For the reasons set forth in the Petition filed herewith and in this Memorandum of Support, Petitioner seeks to modify the Trust to substitute a distribution provision based on a percentage of net value of Trust assets ("unitrust amount") in lieu of net income.

II. ANALYSIS

A. Traditional "Income Trusts" Are Inconsistent With Modern Investment Theory.

The "income trust" has been the conventional trust model. It is characterized by the bifurcation of a trust's value into two components, income and principal, where the income is paid to a current beneficiary for a period of time (*e.g.,* term of years, life), with the principal passing to a remainder beneficiary (or beneficiaries) at the end of the trust term.

Trustees have a fiduciary duty under state trust law to balance the interests of the income beneficiary (who wants to maximize income and will therefore prefer fixed-income investments, *i.e.,* bonds) with the interests of the remainder beneficiaries (who want to maximize growth and will therefore prefer equity investments, *i.e.,* stocks). The Trustee is often placed in a compromising position that is difficult to justify to the income beneficiary, as well as the remainder beneficiaries.

Under the current law governing trust investments, trustees have a duty to invest for maximum total return. (Uniform Prudent Investor Act, California Probate Code section 16047.) Generally, maximizing total return requires the trustee to invest more heavily in equity securities (stocks) rather than in debt securities (bonds). Thus, a trustee faced with a statutory duty to maximize total return may have no choice but to invest more heavily in equities, which may generate dissatisfaction with the income beneficiary if the stock dividend payout rates are low.

In the alternative, a trustee administering a traditional income trust who wants to increase income to satisfy the income beneficiary will have no choice but to decrease the portfolio's allocation of stocks and buy bonds, if the bond market is good. However, this move will likely frustrate the remainder beneficiaries, who will criticize

the trustee for failing to match the performance of the stock market, at least during market upswings. These alternatives place the trustee administering a traditional income trust in a very difficult situation.

B. Adoption of the Unitrust Model in Place of the Traditional Income Trust Model Will Solve the Trustee's Dilemma.

Trusts should address a total investment strategy. A "unitrust" is a trust that provides a beneficiary with a right to periodically receive a fixed percentage of the net value of the trust estate, with the assets revalued at selected intervals, usually annually.

The traditional trust investment strategy does not consider the value of money over time. If a trust has been in effect a long period of time, as the present Rich Trust has been, the value of the principal, in real terms, has less purchasing power due to inflation. The purchasing power of a dollar in 1937 was much greater than it is today. A unitrust investment strategy would allow for an increase in principal, thereby expanding the principal over time, while allowing for an allocation of predictable income.

The key to understanding the Prudent Investor Act is that trustee compliance and potential trustee liability are concerned with the process, not the product. In effect, the Act incorporates Modern Portfolio Theory (MPT) into California law. Diversification, hence increased risk, is acceptable as an investment strategy. In fact, MPT requires a trustee to diversify. Therefore, the trustee must not take undue risk and cannot give up the opportunity for greater returns.

Both the income beneficiary and the remainder beneficiaries will benefit from the proposed investment plan, which is a diversified portfolio.

A payout of 5 percent regardless of investment character would result in a predictable net payout. This predictable payout would allow for more flexibility in the investment plan and the income beneficiary would have a good idea of what he or she could regularly expect as a payout.

The unitrust model is a relatively new concept in private trust design, borrowed from the charitable trust arena. In its most basic form, a private unitrust would provide a payout of 5 percent of the net trust value. In this type of trust, the tension between current yield (favored by the current beneficiary) and long-term growth (favored by the remainder beneficiaries) disappears. Rather than worrying about balancing investment performance between current income and long-term growth, the trustee of a unitrust is free to pursue maximum total return (as required under the Uniform Prudent Investor Act) without being stifled by the principal/income dichotomy.

Studies support the selection of a unitrust percentage in the range of 3 percent to 5 percent, with 3 percent tending to favor slightly the remainder beneficiaries, 5 percent tending to favor slightly the income beneficiary. A unitrust rate greater than 5 percent will, based on historical models, exhaust the trust more quickly. A unitrust payout set at less than 3 percent will enrich the remainder beneficiaries at the expense of the income beneficiary. The Trustee is proposing a payout of 5 percent per year. The income beneficiary in this case is 87 years old; the time horizon will likely not exceed 10 years. Therefore, a 5 percent payout is fair and reasonable.

Under the unitrust model, if the trust grows, the current beneficiary's annual distributions will grow and the share left over for the remainder beneficiaries will grow as well. The unitrust approach should create a better relationship among the trustee, the income beneficiary, and the remainder beneficiaries.

C. Statutory Developments Require Trustees to Invest for Total Return and Encourage Use of the Unitrust Model.

1. The Uniform Prudent Investor Act

Under the Uniform Prudent Investor Act (California Probate Code §§16045-16054), a trustee's investment decisions are not viewed in isolation, but in the context of the investment portfolio as a whole. In effect, the Uniform Prudent Investor Act combines Modern Portfolio Theory (MPT) and California Trust Law.

The linchpin of MPT is the correlation of risk and return. In general, risk and return are directly correlated, *i.e.,* the greater the risk, the greater the potential return; the lower the risk, the lower the potential return. Risk and return are managed through diversification and asset allocation. Thus, the goal of a trustee-investor under

the Uniform Prudent Investor Act is to achieve an acceptable rate of return with the least amount of risk based on the facts and circumstances applicable to the particular trust in question, taking into account the factors enumerated in Probate Code §16047, including general economic conditions, inflation, taxes, total return, liquidity, and costs.

2. The Uniform Principal and Income Act

The second statutory development that encourages the use of the total return (unitrust) model is the Uniform Principal and Income Act (California Probate Code §§16320-16375). The Act implements the California Law Revision Commission's (CLRC) recommendation to adopt the Uniform Principal and Income Act approved by the National Conference of Commissioners on Uniform State Laws in 1997 (with some revisions), and replaces the California Revised Uniform Principal and Income Act.

According to the CLRC Report:

> **The proposed law would also make needed revisions in principal and income rules for consistency with the Prudent Investor Rule embodied in the Uniform Prudent Investor Act (Prob. Code §§16045 to 16054), which was enacted in California in 1995. Existing principal and income rules, which focus on trust accounting principles, can conflict with the overriding duty of a prudent investor to invest trust assets as a portfolio.**

California Law Revision Commission, "Uniform Prudent Investor Act," 29 Cal L Comm'n Reports 245 [1999].

The Act is intended to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of "income" as traditionally perceived in terms of interest, dividends, and rents. It clear that the Uniform Law Commissioners and the CLRC recognize that trustees have entered the era of total return investing for trusts, leaving behind the traditional principal/income dichotomy.

The provision of the Uniform Principal and Income Act found in Probate Code §16336 gives the trustee authority to make adjustments (*i.e.,* "recharacterizations") between principal and income if three conditions are satisfied:

(1) The trustee invests and manages trust assets under the Prudent Investor Rule;

(2) The trust describes the amount that shall or may be distributed to a beneficiary by referring to the trust's income; and

(3) The trustee determines that he or she cannot comply with the statutory duty to invest for total return yet maintain impartiality between classes of beneficiaries unless an adjustment is made.

Thus, if a trustee of a traditional "income trust," such as the one before the Court, believes that investing in a manner consistent with the Prudent Investor Rule tends to favor the current beneficiary over the remainder beneficiaries, or vice versa, the trustee may make adjustments in order to treat what would otherwise be income as principal, or vice versa. Despite built-in statutory safeguards for the trustee, if any beneficiary objects to the adjustments made by the trustee, litigation may ensue. Clearly, this process will result in substantial attorney fees, accounting fees, and investment advisor fees. As a result, some trustees may be hesitant to exercise the power of adjustment, even when appropriate.

New amendments to the Code of Federal Regulations, 26 CFR Parts 1, 20, 25, and 26, were promulgated effective January 2, 2004, to further define and support the concept of the unitrust. Part 1, section 1.643(b)-1, of Title 26 CFR provides the following definition of income under Internal Revenue Code section 643(b): "income under IRC section 643(b) is the amount of income determined under the terms of the governing instrument and applicable law." Section 1.643(b)-1 further states that a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust.

Therefore, under the California Prudent Investor Act and the Uniform Principal and Income Act, the trustee of a unitrust is authorized to adjust income and principal to maintain impartiality between income beneficiaries and remainder beneficiaries. That adjustment includes allocating capital gains between principal and income if those adjustments are currently permitted by state law, which they are in California. The trust instrument must so specify, hence the petition for modification of the Trust language.

Converting the Trust to a unitrust, as Petitioner requests herein, will eliminate the need to make time-consuming and expensive adjustments each year, thereby simplifying administration and minimizing costs, all to the benefit of the beneficiaries.

D. Probate Code Section 15409 Allows Modification of a Trust on Trustee's Petition to the Court Based on Changed Circumstances.

Probate Code Section 15409, subdivision (a), provides, in pertinent part:

> **On petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust. In this case, if necessary to carry out the purposes of the trust, the court may order the trustee to do acts that are not authorized or are forbidden by the trust instrument.**

In this case, the Trust was created in 1937, many years before the California Legislature adopted the Uniform Prudent Investor Act and the Uniform Principal and Income Act. These legislative developments amount to a "change of circumstance" that was not known to the Trustor and could not have been anticipated by him at the time he created the Trust.

Based on the foregoing, Petitioner respectfully requests that the Court grant the Petition and approve the proposed modification of the Trust from a "net income" trust to a total return unitrust with a payout of 5 percent of the net value of the Trust assets.

Respectfully submitted,

Date: _ _ _ _ _ _ __[*Signature*]__
JAMES P. LAMPING
Attorney for Petitioner, MARY M. RICH

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§14A.6 B. Lifetime Gift of Marital Trust

Depending on the personal wealth, donative intent, life expectancy, and current needs of the surviving spouse, the spouse should consider making a gift of all or part of the income interest in the marital trust to the remainder beneficiaries. This has the effect of freezing the transfer tax value of the trust assets and removing from the spouse's taxable estate future appreciation of the trust assets and future income payments not consumed by the spouse. For partial gifts, this requires that the marital trust first be divided into a gift trust and a nongift trust, unless the remainder beneficiaries of the trust are charities or individuals who are not family members of the surviving spouse for purposes of the special valuation rules in IRC §2702. See §14A.8.

If the surviving spouse makes an inter vivos transfer of all or any part of his or her right to income, he or she is deemed to make a transfer of the entire trust, reduced by the value of any portion of the income interest retained after the gift that is a "qualified interest." IRC §§2511, 2519, 2702; Treas Reg §25.2519-1(a), (g), Examples 4-5. A tax under IRC §2519 is imposed on the value of the QTIP assets, less the value of the income interest, which is taxable under IRC §2511. To offset the imposition of the gift tax, the QTIP assets are no longer taxable in the surviving spouse's estate. IRC §2044(b).

If the entire income interest is transferred, the result is not inequitable. The transferees are liable for the gift tax, and the gift tax paid by the transferees is consideration for the transfer that reduces the amount of the gift. IRC §2207A(b); Treas Reg §25.2519-1(c)(4). The spouse makes an additional gift if the spouse fails to exercise the IRC §2207A(b) right of recovery (see §12.26), and any delay in exercising the right is treated for gift tax purposes as an interest-free loan. Treas Reg §25.2207A-1(b)(1). See IRS Letter Rulings 200230017, 200027001. A donor who does not intend to exercise a right to recover gift tax may execute a waiver of that right, thereby completing the gift of the right to recover the gift tax and avoiding interest-free loan treatment. Treas Reg §25.2207A-1(b)(2). See example in §14A.7.

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§14A.7 1. Calculation of Gift Tax on Marital Trust

The gift will trigger a deemed gift of the entire remainder interest even if the spouse retains a portion of the income interest. IRC §2519. As a consequence, the total gift is the value of the trust reduced by the value of any retained income interest. If the surviving spouse retains a portion of the income interest, an equivalent portion will be included in the survivor's estate under IRC §2036. This does not result in double taxation of the §2036 portion because gifts of property later included in the estate are ignored in computing the estate tax. IRC §2001(b). However, the deemed gift uses up the survivor's gift tax applicable exclusion amount and will result in a prepayment of estate taxes without interest if gift tax is paid on property later included in the survivor's estate. This may unfairly benefit the remainder beneficiaries of the QTIP. Furthermore, if the remainder beneficiaries are the spouse's children, the gift of a portion of the income interest will trigger a gift equal in value to the entire trust estate because the retained income interest will be valued at zero under the special valuation rules in IRC §2702. Treas Reg §25.2519-1(g), Examples 4-5. The effect of IRC §2519 can be further mitigated in these cases by dividing the QTIP trust into multiple trusts before assigning the income interest in one of them. See IRS Letter Rulings 200530014, 200250033, 200137022, 200044034.

EXAMPLE: In the married settlor hypothetical, the survivor's trust has a date-of-distribution value of $5,400,000, the nonexempt marital trust has a value of $937,500, and the exempt marital trust has a value of $1,191,237. See §14.101. Assuming the spouse consumes all of the income of the survivor's trust and the nonexempt marital trust but none of the income of the exempt marital trust (the value of which increases to $500,000) and the spouse makes no further lifetime gifts, trust assets having a value of approximately $7,840,000 will be included in the spouse's gross estate, with a resulting estate tax liability of $1,950,000 ($650,000 paid from the nonexempt marital trust unless the spouse waives the right to recovery under IRC §2207A, and $1,300,000 paid from the survivor's trust). If instead the spouse makes a gift to the remainder beneficiaries of the income interest in the exempt marital trust, using approximately $250,000 of the spouse's applicable exclusion amount to shield the gift, the trust assets included in the spouse's estate will be approximately $7,340,000, with a resulting estate tax liability of $1,840,000 ($420,000 paid from the nonexempt marital trust and $1,420,000 paid from the survivor's trust).

Like all lifetime gifts, the gift freezes the value of the gifted QTIP trust and avoids estate tax on future appreciation of trust assets. In the above example, the gift avoids estate tax on $250,000 of appreciation. Note, however, that the estate tax paid by the survivor's trust is increased. This may be important if the survivor's beneficiaries and the QTIP beneficiaries are not the same.

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§14A.8 2. Partial Gift of Marital Trust

In IRS Letter Ruling 200013015, the partition of a QTIP trust between the surviving spouse and charitable remainder beneficiary was treated as a disposition of the income interest resulting in a gift of the remainder by the spouse, but the gift qualified for the gift tax charitable deduction. In IRS Letter Ruling 200324023, the division of a QTIP trust and renunciation of the spouse's interest in one of the shares caused that share to become a charitable remainder unitrust under the terms of the QTIP remainder, resulting in a gift by the spouse that qualified for a gift tax charitable deduction. If the survivor purchases the QTIP remainder interest, the survivor is deemed to make a gift equal to the greater of the value of the remainder or the amount of consideration paid. Rev Rul 98-8, 1998-1 Cum Bull 541.

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§14A.9 C. Creating Qualified Personal Residence Trust (QPRT) for Survivor's Trust Property

If the survivor's trust contains the family residence or other residential property such as a vacation home (or farm or ranch property used primarily as a residence) and it is reasonably certain that the surviving settlor will have a taxable estate, the trustee should consider transferring the property to one or more irrevocable qualified personal residence trusts (QPRTs) benefiting the remainder beneficiaries of the survivor's trust. Under the special valuation rules, retained interests in property are generally valued at zero for gift tax purposes when the remainder interest is transferred to family members—with the consequence that the taxable gift will be equal to the full fair market value of the property—but there is an exception for transfers of remainder interests in residential property. IRC §2702(a)(3); Treas Reg §25.2702-5. (There is also an exception for retained interests in the form of an annuity or unitrust interest under IRC §2702(b), but the payment of an annuity or unitrust amount to the transferor generally negates the transfer tax benefits of the gift of the remainder interest.) Assuming that the spouse expects to retain the property and continue to use the property as a residence for an extended period, the creation of a QPRT will allow the transfer of the property to the beneficiaries at a reduced transfer tax cost. The cost is reduced both because the gift tax value of the property is discounted for the term of the retained interest and because any gift tax paid on the transfer will be removed from the survivor's estate. As a result, the funds used to pay the gift tax will not be subject to estate tax under IRC §2035 unless the survivor dies within 3 years. The transfer also avoids estate tax on any future appreciation of the property. Additional valuation discounts can be obtained if the survivor transfers fractional interests in the property to separate trusts for multiple remainder beneficiaries.

This technique should not be used if the survivor is not in good health, because the property will be included in the survivor's estate under IRC §2036 if the survivor dies during the trust term. For this reason, shorter trust terms should generally be used for older settlors, although less is lost if an older settlor fails to survive the term because the corresponding reduction in transfer tax value of the gifted property interest is less with a shorter term. The survivor should be advised that the property also may be included in the survivor's estate if the survivor continues to reside on the property after the end of the term and fails to pay fair market rent to the successor trustee or to the beneficiaries in the case of outright distribution. The transfer has the further drawback that the beneficiaries do not receive a second step-up in basis on the death of the survivor. Again, the second step-up in basis that would otherwise occur on the death of the survivor is likely to be less with an older settlor because there will be less time for appreciation before the second death.

The survivor generally should not create a QPRT for the family residence if it is possible that the survivor may soon wish to move to a smaller residence. The tax benefits of the trust are reduced if the property is sold by the trust before the end of the term, because the QPRT regulations require that the trust must then be converted into a grantor retained annuity trust (GRAT) that must make cash payments to the settlor. For this reason, vacation homes and ancestral property often are better candidates for a QPRT. However, the settlor may substitute residential property of equal value for property in the trust. The settlor also may purchase the property from the trust at the end of the original trust term, but the QPRT regulations provide that the trust must prohibit the settlor from purchasing the property after the end of the term if the trust continues to be taxed as a grantor trust. For a complete discussion of QPRTs with forms, see Drafting California Irrevocable Trusts, chap 17 (3d ed Cal CEB 1997).

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III. ON THE DEATH OF THE SURVIVING SPOUSE

§14A.10 A. Division of Survivor's Trust Into Exempt and Nonexempt Trusts

This chapter has considered the need for division of the marital trust (or, less commonly, the credit trust) into GST-exempt and nonexempt trusts if the deceased spouse's remaining applicable exclusion amount exceeds (or is less than) the deceased spouse's remaining GST exemption. See §§14.45-14.56. The same problem may arise on the death of the surviving settlor if the total of the survivor's trust, plus any nontrust property of the survivor, and the nonexempt marital trust (which is included in the survivor's taxable estate and for which the survivor is the GST tax transferor), exceeds the surviving settlor's remaining GST exemption.

In the hypothetical, the survivor's trust has a value of $5,400,000, the nonexempt marital trust has a value of $937,500, and the exempt marital trust has a value of $1,191,237. See §14.101. Assuming that the survivor consumes all of the income and appreciation but none of the original principal of all three trusts and the survivor makes no further lifetime gifts, trust assets having a value of approximately $7,500,000 will be included in the survivor's taxable estate, with a resulting estate tax liability of approximately $1,800,000 ($900,000 to be paid from the nonexempt marital trust, unless the survivor waives the right to recovery under IRC §2207A, and $900,000 to be paid from the survivor's trust), while the survivor will have $3,500,000 in remaining GST exemption equal to the remaining applicable exclusion amount. Further assuming that the executor allocates none of the surviving settlor's GST exemption to the nonexempt marital trust, the trustee divides the survivor's trust into an exempt trust with a value of $3,500,000 and a nonexempt trust with a value of $1,900,000. The executor allocates the entire $3,500,000 of GST exemption to the exempt survivor's trust and pays the estate tax from the nonexempt survivor's trust.

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§14A.11 B. Combining and Dividing Exempt and Nonexempt Trusts

In some cases, multiple GST-exempt and nonexempt trusts for the same beneficiaries may exist after the second death. Once the need to maintain the marital trust for the benefit of the surviving survivor is removed, it may be possible to combine trusts and then redivide the combined trusts into trusts for particular beneficiaries, assuming there is a need for continuing trusts and the trustees have the necessary authority or can obtain court approval. In the example in §14A.10, there are exempt and nonexempt marital trusts and survivor's trusts. There is also an exempt credit trust that still exists on the second death, assuming that the survivor has an interest in the trust such as a limited power of appointment or discretionary withdrawal right, as is usually the case. Further assuming that the remainder beneficiaries of the exempt marital trust and the exempt credit trust are the same (*e.g.,* children and grandchildren of the deceased settlor), these trusts could be combined into a single trust followed by outright distribution of a portion of the trust principal to the children with continuing trusts for grandchildren, depending on the terms of the trusts.

If these beneficiaries are also the remainder beneficiaries of the survivor's trust, it may be possible to combine all three exempt trusts into one trust and combine the two nonexempt trusts into another trust. These trusts could then be divided into individual trusts for the beneficiaries or retained as pot trusts. In some cases, these actions can be facilitated by the exercise of special powers of appointment that the survivor or beneficiaries may have over the various trusts.

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Source: Estate Planning/California Trust Administration/14A Further Steps After the Death of the First Spouse/§14A.12 C. Using Insurance Trusts to Purchase Trusts Assets

§14A.12 C. Using Insurance Trusts to Purchase Trusts Assets

A common element of many estate plans is the creation of inter vivos irrevocable life insurance trusts (ILITs) funded with annual exclusion gifts or taxable gifts used to pay premiums on life insurance policies on the lives of one or both the settlors while avoiding inclusion of the proceeds received by the trusts in the insured's estate under IRC §2042. These proceeds are generally received free of income tax under IRC §101. Often a second-to-die policy is used, although single-life policies also may be used, in which case the insurance proceeds from the first death may be retained in trust until the second death. In either scenario, the ILIT purchases the assets of the marital trust or the survivor's trust, or lends money to the trusts in exchange for promissory notes secured by those assets, although the ILIT trustee is not required to do this. These trusts in turn use the funds to pay estate taxes, and the assets or promissory notes are then distributed to the beneficiaries of the ILIT or held in continuing trust, depending on the terms of the trust. In these purchase or loan transactions, the trustees must take care to assign values to trust assets that are consistent with any valuation discounts claimed on the IRS Form 706 estate tax return. See §14.72.

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§14A.13 D. Special Use Valuation Election on Second Death

As noted in §14.66, it may be possible to use the IRC §2032A special use valuation election on both the first death and the second death for special use property allocated to the marital trust, provided that the surviving settlor or other family members have continued to use the property for a qualified use in the meantime and all of the other qualifications are met (*e.g.,* 25 percent of the survivor's estate must consist of special use property). The election is also available for special use property that was allocated to the survivor's trust on the first death. In a community property estate, one-half interests in the property often are assigned to the survivor's share and the decedent's share on the first death, and valuation discounts are claimed for the property interests assigned to the decedent's share and allocated to the marital trust or credit trust. Rev Rul 93-12, 1993-1 Cum Bull 202; *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248; *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999. These valuation discounts will continue to be available on the second death for property interests allocated to the survivor's trust and the marital trust because the survivor's property is not aggregated with QTIP property included in the survivor's estate under IRC §2044. See §14.78.

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Source: Estate Planning/California Trust Administration/14A Further Steps After the Death of the First Spouse/§14A.14 E. Duty of Consistency on Second Death

§14A.14 E. Duty of Consistency on Second Death

In some cases, counsel may become aware that a QTIP election was made on the first death for a trust that was not a marital deduction qualifying trust under IRC §2056 because the surviving spouse did not have the requisite qualifying income interest for life. In these cases, counsel should consider taking the position that some or all of the trust is not included in the survivor's estate under IRC §2044. However, the IRS may take the position that the property must be included under the duty of consistency. See §14A.15.

NOTE: Under Rev Proc 2001-38, 2001-1 Cum Bull 1335, a QTIP election for a trust is treated as a nullity if neither a full nor partial election was needed for that trust to reduce the estate tax to zero. See §12.56. In IRS Letter Ruling 200729028, the IRS ruled that a credit shelter trust was not included in the estate of the surviving spouse under IRC §2044 when a QTIP election was inadvertently made for property passing to both the marital trust and the credit shelter trust on the first death.

Whenever trust property is included in the estate of the surviving settlor (or deceased settlor), the duty of consistency also arises when the eventual recipient attempts to claim that the basis of the property exceeds the claimed estate tax value. See §14A.16.

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§14A.15 1. Avoiding Inclusion of Marital Trust Property

In *Estate of Buder v U.S.* (ED Mo 2005) 372 F Supp 2d 1145, aff'd (8th Cir 2006) 436 F3d 936, a case involving an erroneous allowance of a marital deduction for a defective QTIP trust on the husband's death, the court held that the trust was not included in the wife's estate. The court held that the government could equitably recoup a portion of the estate taxes not paid in the husband's estate, but the taxes that could be recouped were limited to the portion of the taxes that would have been paid by the same beneficiaries on the husband's death. The doctrine of equitable recoupment is applied when a single transaction is subject to two taxes or no taxes on inconsistent legal theories, and there is a sufficient identity of interest between the parties if the parties are not the same. The court relied on *Estate of Vitt v U.S.* (8th Cir 1983) 706 F2d 871 to support the proposition that the estates of a husband and wife can have a sufficient identity of interest in a case involving the same property. However, the court noted that in *Buder*, unlike *Vitt*, the beneficiaries of the two estates were not the same. Accordingly, the court reduced the amount of the equitable recoupment to 55 percent of the tax that was not paid on the death of the husband because the beneficiaries of the defective QTIP trust would have paid only 55 percent of the tax that would have resulted from disallowance of the marital deduction.

PRACTICE TIP: Courts may be wary of claims that trust property should not be included in the estate of the surviving settlor because the trust did not qualify for the QTIP election. In *Estate of Cavenaugh v Commissioner* (5th Cir 1995) 51 F3d 597, the court rejected a claim that trust property did not qualify for the QTIP election because state law permitted the accumulation of trust income. The court held that the lack of a provision for accumulation of trust income indicated the testator's desire that the income be paid at least annually.

In *Warner v U.S.* (CD Cal 2006) 98 AFTR2d 6136, the court held that the trust in question qualified for the QTIP election because the decedent's intent to pay trust income to the spouse at least annually could be inferred from the spouse's right to invade trust principal each year to supplement income. Although it is now a moot point, unless the decision is appealed, it is interesting to note that that the IRS might have had trouble making the argument that the duty of consistency estopped the ultimate beneficiaries of the QTIP trust from claiming that the trust was not eligible for the QTIP election. Provided that there is sufficient identity of interest between the executor and the ultimate beneficiaries, beneficiaries can be estopped by that executor's claim of a marital deduction for the trust property even though the beneficiaries did not participate in making the election. But in this case, it appears that the interests of the executor (decedent's surviving spouse) were actually adverse to those of decedent's sons, who were the remainder beneficiaries of the trust. The QTIP election presumably increased the income paid to the spouse, but it is quite possible that the election also caused the trust to be taxed eventually in the spouse's estate in higher tax brackets than would have applied if the estate tax had been paid when the decedent died.

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§14A.16 2. Rebutting Estate Tax Valuation Presumption

Under IRC §1014(a)(1), the basis of property in the hands of the person acquiring the property from a decedent is the fair market value of the property on the date of death. Under Treas Reg §1.1014-3(a), the estate tax value of the property is prima facie evidence of the fair market value of the property. Although the regulation does not preclude rebutting the presumption that results from the prima facie evidence, the duty of consistency can have the effect of making the presumption conclusive.

Generally, the duty of consistency is applicable if the taxpayer made a representation of fact for tax purposes in one tax year, the IRS acquiesced in or relied on that fact for that year, and the taxpayer attempts to change the previous representation in such a way as to harm the IRS. If this test is met, the IRS may act as if the previous representation continued to be true, even if it is not. *Estate of Ashman v Commissioner* (9th Cir 2000) 231 F3d 541 (duty of consistency prevented claim that earlier-year pension rollover was invalid because it was not accomplished within 60 days). The duty of consistency can bind a beneficiary of an estate to a representation made on an estate tax return if the beneficiary was a fiduciary of the estate. In *Janis v Commissioner* (9th Cir 2006) 461 F3d 1080, the court held that estate executors who inherited an art gallery must use the "blockage"—discounted estate tax value of the individual art works as the "costs of goods sold" in determining profit and loss on later sales of the works. Under the duty of consistency, the beneficiaries were estopped from claiming that the fair market value of the artworks at death was different from the estate tax value.

However, beneficiaries who are not fiduciaries may present evidence to rebut the presumption that the fair market value of trust property is the estate tax value. In *Elizabeth G. Augustus* (1939) 40 BTA 1201, acq 1940-1 Cum Bull 1, aff'd (6th Cir 1941) 118 F2d 38, the Service determined that shares of stock in a publicly traded company had an estate tax value of $82 per share, after applying a blockage discount, when the average selling price of the stock on the date of death was $86.70 per share. The beneficiary later used this market value in calculating gains on the sale of the stock. The court sided with the taxpayer, noting that the estate tax value is only prima facie evidence of fair market value and may be shown to be erroneous. The court concluded that the stipulated facts did not support the application of the blockage rule, because the volume of trading in the particular stock was very large compared with the block of stock to be valued.

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§14A.17 IV. FUNDING STALE TRUSTS

Whether by design or neglect, marital subtrusts often are not funded in the first year or two following the death of the first spouse to die. Legitimate reasons for postponing or accelerating subtrust funding are discussed in chap 14. When subtrusts are not funded for many years, they may be referred to as unfunded or "stale" trusts. This problem may be particularly prevalent in areas where mass marketing of living trusts has taken place and the surviving spouse is a believer in the living trust myth that nothing needs to be done on the death of a person with a living trust.

Funding stale trusts may occur during the lifetime of the surviving spouse or after the survivor's death. In some cases, modification of the trust may be required if the trust has become outdated. See chap 16. Whenever it occurs, funding a stale trust raises a number of tax and accounting issues that may require IRS guidance or other professional advice, including estate tax issues (see §§14A.18-14A.22), income tax issues (see §14A.23), and liability concerns (see §14A.24). For an example of funding a stale trust, see §14A.25.

Much like any other trust administration, stale trust funding requires a systematic approach. Current and date-of-death values for assets should be collected as soon as possible. An estate tax return should be prepared and filed for the first death, if required. The marital deduction formula must be determined, and more specifically, whether the trust document provides for a two-trust division or a three-trust division. The ratio of the deceased spouse's share of the assets to the total value of all assets must be determined, both for the date of death and currently. Often assets will have been sold and additional assets acquired following the death of the first spouse.

The surviving spouse's income tax returns are frequently the most useful tool for tracing assets, income, and losses during the period following the first death. Indeed, in many cases it may be impossible to perform a tracing without the survivor's income tax returns. Once the subtrust funding has been completed, court approval often should be obtained to prevent challenges by beneficiaries in the future.

The core issues in a stale trust funding may be summarized as follows:

- All or part of the credit trust may be included in the estate of the surviving spouse under IRC §2036(a).
- The credit trust may not be recognized. See, *e.g., Estate of Hester v U.S.* (WD Va 2007) 2007-1 USTC ¶60,537, 99 AFTR2d 1288.
- Litigation may result, because decisions made in an effort to reconstitute the subtrusts may inure to the benefit of some beneficiaries and the detriment of others.
- The advisors involved may face malpractice liability.

Some of the most critical elements in completing a stale trust funding after the death of the first spouse, but before the death of the second spouse, may be summarized as follows:

- Determining the target amount for each subtrust.
- Being cognizant of taxable *Kenan* gains on funding. See §14A.22.
- Paying interest on pecuniary formula gifts. See §14A.26.
- Considering whether to go to court to terminate the credit trust (and marital trust) if there will be no estate tax on the second death.
- Determining whether prorata or nonprorata funding should be used.
- Deciding whether to file income tax returns for the administrative trust and any subtrusts for the period following the death of the first spouse.
- Disclosing the malpractice of prior advisors to avoid the attorney being subject to malpractice liability.
- Working with the client's CPA and financial advisor to reach practical solutions.

When confronted with a stale trust funding case after the death of the second spouse, the issues are very similar except that a second administration will be needed for the surviving spouse.

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§14A.18 A. Estate Tax Issues

When subtrust funding is delayed for many years, the estate tax consequences may range from modest to severe depending on whether funding occurs before the death of the surviving spouse and how the trust property was used in the meantime. The most urgent concern is the possibility that some or all of the trust property that could have been used to fund the credit trust on the first death will be included in the estate of the surviving spouse if funding does not occur until the second death. See §14A.19. A more common concern may be that a portion of the appreciation of trust assets that might have been allocated to the credit trust may be allocated to the marital trust, or the survivor's trust. See §14A.20.

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§14A.19 1. Inclusion of Credit Trust Property in Survivor's Estate

The doomsday scenario in stale trust funding is one in which the surviving spouse never files an estate tax return, fails to fund the credit trust as provided by the trust document, and then uses the assets of joint revocable trust indiscriminately until the survivor's death, at which time the fair market value of the remaining trust property exceeds the applicable exclusion amount. Under these circumstances, the likely result is that the entire trust property will be included in the survivor's estate under IRC §2033 (with respect to the decedent's share) or IRC §2038 (with respect to the survivor's share).

In *Estate of Hester v U.S.* (WD Va 2007) 2007-1 USTC ¶60,537, 99 AFTR2d 1288, the court held that assets misappropriated by the surviving spouse from a trust created by the will of the deceased spouse were included in the survivor's estate as property in which the survivor had an interest under IRC §2033. The surviving spouse had a qualifying income interest for life in the trust property, but it appears that no QTIP election was made because in that case the trust would have been included in the survivor's estate anyway under IRC §2040. The spouses' children were the remainder beneficiaries of the trust. The court stated that the surviving spouse exercised dominion and control over the assets as though they were his own without an express or implied recognition of an obligation to repay and without restriction as to their disposition, commingling the misappropriated assets with his own to the extent that "it was impossible for anyone to determine which interest in the whole belonged to [the survivor] and which interest in the whole belonged to his children." The court held that the estate was not allowed a deduction under IRC §2053 for alleged indebtedness to the trust because no claim was ever made.

PRACTICE TIP: The estate inclusion and claim deduction issues presented in the *Hester* case become relevant whenever a surviving spouse fails to fund a credit trust. Planners confronted with these kinds of cases might advise clients of the importance of either preserving the legal enforceability of any claims of the credit trust or structuring the estate administration on the death of the surviving spouse in a manner that follows the form of providing for a settlement of such claims, so that the trust property included in the survivor's estate is offset by a deduction for the claims of the remainder beneficiaries.

Even if the doomsday scenario is avoided because the survivor's estate is allowed a deduction that offsets inclusion of the credit trust, failure to fund the credit trust during the survivor's lifetime may still represent a lost opportunity to remove additional trust property from the survivor's estate. See §14A.20.

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§14A.20 2. Lost Opportunity to Remove Additional Trust Property From Survivor's Estate

Failure to fund marital subtrusts for several years after the first death, or until the death of the surviving spouse, may increase the amount of trust property eventually included in the survivor's estate for two reasons. First, the survivor may be unable to deplete only the survivor's trust (or marital trust) if the survivor consumes a portion of the trust principal because trust income is insufficient. See §14A.21. Second, even if the trust principal has not been depleted, the survivor may have lost a valuable opportunity to allocate appreciated assets to the credit trust. See §14A.22. For these reasons, marital subtrusts generally should be funded as soon as possible after the first death.

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§14A.21 a. Depletion of Credit Trust

Ordinarily, the surviving spouse is advised to make distributions or gifts from the survivor's trust (or marital trust) rather than the credit trust to reduce the survivor's estate, especially if the survivor retains the right to take discretionary distributions of trust principal from the credit trust as needed. However, one-half of the trust community property presumably will be allocated to the survivor's trust whenever subtrust funding finally occurs unless the trust document assigns specific trust property to the decedent's share. Examples of stale trust funding and its impact on target amounts for the various subtrusts are discussed in §14A.26.

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§14A.22 b. Unnecessary Allocation of Appreciated Assets to Marital Trust

The authors have received informal guidance from the IRS in a case involving a pecuniary marital formula suggesting that assets allocated to the credit trust in a late subtrust funding must fairly represent appreciation and depreciation of trust assets whether or not the assets to be put into the credit trust are specified in the trust document, citing Rev Proc 64-19, 1964-1 Cum Bull 682; *Matter of Goutmanovich* (Sur Ct 1980) 432 NYS2d 768. This would not ordinarily be true in a timely subtrust funding with a typical pecuniary marital/residuary credit formula with date-of-distribution funding. For example, if a husband and wife had total community property of $8 million, the decedent's share of the trust on the first death would be $4 million, the marital trust ordinarily would be funded with $2 million in assets (in 2007), while the credit trust would be funded with $2 million in assets plus income and appreciation during the administration period, and all future appreciation on credit trust assets (which may be selected for growth potential) would pass to the remainder beneficiaries free of estate tax. In selecting the assets to be funded into the credit trust in a timely allocation, the trustee has discretion to use nonprorata funding to select those assets that are expected to have the most appreciation, so that the maximum value will be removed from the estate of the surviving spouse. However, in a stale trust situation, this may not be possible. For example, the IRS would likely challenge a decision by the trustee to allocate assets that have appreciated disproportionately between the date of death and the date of funding to the credit trust. With the benefit of hindsight, the trustee is in a much better position to evaluate which assets are likely to outperform others in the future. If the trustee attempts to use the experience gleaned from the period following the death of the first spouse to gain an advantage in selecting assets to be removed from the survivor's taxable estate, the IRS may very well attack the legitimacy of the entire transaction. While there is not a bright-line rule on this point, it could even be argued that the trustee is required to fund each asset on a prorata basis.

It bears emphasis that this will not change the target amount of the principal to be funded into the marital trust. Assume that the decedent's share of trust assets in the above example has appreciated to $10 million. Because the marital trust is a fixed pecuniary amount as of the date of death, it will still receive its initial $2 million. Unless the trust provides to the contrary, interest must be paid on this amount at a rate of 7 percent commencing 1 year after the date of death. Moreover, the funding of a pecuniary gift with assets in kind using date-of-distribution values is a taxable event, causing realization of *Kenan* gain or loss (if an election was made under IRC §645) equal to the difference between the date-of-death value and the date-of-distribution value. Treas Reg §§1.661(a)-2(f)(1), 1.1014-4(a)(3); Rev Rul 56-270, 1956-1 Cum Bull 325; Rev Rul 60-87, 1960-1 Cum Bull 286; *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217. See §14.31. The credit trust would then receive the residue (*i.e.*, $8 million, less capital gain taxes from *Kenan* gain, expenses of administration, and interest payable to the marital trust).

While there may be a temptation to allocate assets in such a way as to avoid *Kenan* gain, bear in mind that the trustee is in a vulnerable position in a stale trust situation. In substance, the position of the IRS has been "we will most likely respect stale trust funding if you are fair, but don't get cute." The stale trust funding should be handled as though every decision will be closely scrutinized by the IRS, because there is a very high probability that this will be the case.

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§14A.23 B. Income Tax Issues

When subtrust funding is delayed for many years, the income tax consequences may include the failure to file returns and the resulting inability to effectively allocate the income and expense items actually reported on the surviving spouse's return among the various subtrusts and beneficiaries. The consequences also may include the use of historical basis rather than stepped-up basis to calculate depreciation and capital gains. See §14A.25.

PRACTICE TIP: In this context, the position usually taken is that the subtrust does not exist prior to funding. A trust does not exist without trust property. Prob C §15202. See discussion in §14.3. Thus, until funded, no return is due for the subtrust. Some practitioners have suggested filing informational Form 1041 returns for each year of the administrative trust and state that the income from such returns was reported on the surviving spouse's Form 1040 returns.

The authors have received informal guidance from the IRS suggesting that returns cannot be filed for unfunded trusts unless the trust first takes action to get the trust funded nunc pro tunc as of the deemed date of funding. The guidance also suggests that at least a rough draft of unfiled trust returns must be made to determine that there would be no difference to the surviving spouse's income tax before the IRS will agree that the returns need not be filed.

That determination depends on the assumption that all income after the date of death has been reported and that no capital gains or losses were realized after the date of death. Capital gains of a marital subtrust ordinarily are taxable to the trust, not the settlor. The guidance also states that returns after the survivor's death probably would be needed even if earlier returns could be avoided. In any case, the issue must be coordinated with the IRS estate tax attorney in the likely event that the delinquent estate tax return of the deceased spouse is audited.

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§14A.24 C. Liability Concerns

In some cases, delayed funding may create liability concerns for the surviving spouse, particularly if the trust estate has been depleted. In *Heaps v Heaps* (2004) 124 CA4th 286, 21 CR3d 239, for example, the court held that the sale of community property by a revocable trust in exchange for a joint tenancy promissory note did not revoke the trust with respect to the property. See §16.3. After the first death, the surviving spouse ignored the existence of the deceased spouse's trust and transferred the note to a new trust. Therefore, the court held that the spouses' children were entitled to a share of the trust property.

In *Estate of Hester v U.S.* (WD Va 2007) 2007-1 USTC ¶60,537, 99 AFTR2d 1288, the surviving spouse misappropriated the assets of a trust created by the deceased spouse and then incurred $1 million in trading losses, for which the survivor's estate would have been liable if a claim had been filed. See §14A.19. *Hester* involved a trust that was actually funded on the first death, but the result would have been the same if the survivor had simply failed to fund the decedent's share of a joint revocable trust.

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§14A.25 D. Example of Funding Stale Trusts

Husband and Wife prepare and fund a properly drafted revocable marital deduction/credit shelter type trust in 1998. The trust is funded with their home, a rental duplex, and a brokerage account with a basis of less than $50,000. All assets are declared to be community property under the terms of the trust. Husband dies in 2002. No estate tax return is filed, and no assets are allocated or appraised.

Between 2002 and 2007, the entire stock portfolio is sold and all sales are reported on Wife's Form 1040 tax returns at historical basis. Depreciation on the rental property is reported on the returns at historical basis. Wife has now died and the family comes into the office for advice. The assets have appreciated in value. The attorney recommends the following steps:

- Promptly file amended Form 1040 for 2002 claiming a step-up in basis for the rental duplex to extend the statute of limitations on the return.
- Have all assets appraised as of 2002.
- Review all personal income tax returns.
- Immediately file a late Form 706 for Husband's estate requesting an early audit. No estate tax will be due.
- With the benefit of perfect hindsight, allocate the assets between the marital share and the credit share as of Husband's date of death. However, the IRS may insist that the credit share fairly represent the appreciation and depreciation of trust assets. See §14A.22.
- Consider filing Form 1041's to properly reflect the trust level transactions. Since all income will be reported on Wife's Form 1040, late Form 1041's may be filed without penalty.
- File amended Form 1040's for intervening years reporting depreciation of rental property on proper stepped-up basis and showing proper capital gains on all stock transactions. Request refunds.
- File Wife's Form 706 timely requesting an early audit. The attorney may have closing letter on Husband's estate by this time.

The above example is based on an actual case reported by attorney James V. Quillinan of San Jose in a CEB program entitled Estate Planning Scams, Botched Trusts and Other Disasters (July/Aug. 2007). The attorney reported that these steps resulted in income tax refunds to the clients of more than $150,000 and both estate tax returns accepted as filed.

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Source: Estate Planning/California Trust Administration/14A Further Steps After the Death of the First Spouse/§14A.26 E. Examples, Impact of Formulas on Funding Trusts

§14A.26 E. Examples, Impact of Formulas on Funding Trusts

The type of subtrust funding clause contained in a trust may have a significant impact on the allocation of appreciation. A subtrust funded by reference to a pecuniary amount and date-of-distribution value funding will not share in appreciation during the administration, whereas a fractional share or fairly representative date-of-death value pecuniary trust will share in that appreciation. For a discussion of how the various formulas are designed to operate, see chap 14.

Several examples will illustrate the consequences. Assume that the decedent died in 2007 (when the applicable exclusion amount was $2 million) and the decedent and spouse owned assets worth $6 million, all of which were community property. This means that, as of the date of death, $3 million (*i.e.*, the decedent's one-half interest in the community property) is the decedent's share of the trust. Many years later, the total assets of the trust have increased to $16 million, meaning that the value attributable to the decedent's interest has increased to $8 million. In other words, the decedent's share of trust assets has appreciated by $5 million (from $3 million to $8 million), assuming that none of the increase is attributable to the accumulation of trust income belonging to the surviving spouse.

- With a pecuniary marital/residuary credit date-of-distribution funding formula clause, $1 million (the marital deduction dollar amount fixed at the date of death, as shown on p 2 of the federal estate tax return) would pass to the marital trust. The remaining $2 million, plus all of the $5 million in appreciation, less interest paid to the marital trust for the period from 1 year after the date of death to the date of distribution (see §14A.22), would pass to the credit trust.
- With a pecuniary credit/residuary marital date-of-distribution funding formula clause, $2 million (the dollar amount of the decedent's remaining applicable exclusion amount fixed at the date of death, as shown on p 2 of the federal estate tax return) would pass to the credit trust. The remaining $1 million, plus all of the $5 million in appreciation, less interest paid to the credit trust for the period from 1 year after the date of death to the date of distribution (see §14A.22), would pass to the marital trust.
- With a fractional share formula, appreciation will be divided proportionately between the two subtrusts, based on the relative values of the marital and credit trusts, as shown on p 2 of the estate tax return. An identical result is reached with a fairly representative date-of-death funding pecuniary formula. Thus, the marital and credit trusts would start with $1 million and $2 million, respectively, and the $5 million appreciation would then be allocated one-third ($1,000,000/$3,000,000) to the marital trust and two-thirds ($2,000,000/$3,000,000) to the credit trust.

These examples are set forth in the following table:

Funding Formula	Credit Trust	Marital Trust
Pecuniary Marital/ Residuary Credit	$7 million (less interest)	$1 million (plus interest)
Pecuniary Credit/ Residuary Marital	$2 million (plus interest)	$6 million (less interest)
Fractional Share or Fairly Representative Pecuniary	$5,333,333	$2,666,667

Some drafters provide for only a survivor's trust and credit trust (with no marital trust) on the logic that the assets of the marital trust will be included in the survivor's taxable estate in any event. However, this ignores the possibility of obtaining valuation discounts by fractionalizing assets between the survivor's trust and the marital trust under the Tax Court decision in *Estate of Harriett R. Mellinger* (1999) 112 TC 26, acq 1999-2 Cum Bull 763. See §14.78. In addition, a marital trust can be used to prevent the surviving spouse from disinheriting the remainder beneficiaries as to those assets, particularly in a blended-family situation. If the trust document provides for only a two-trust division, the wrong type of funding formula can have disastrous consequences. (As discussed below, a similar issue arises when a trust

document provides for a three-trust division and there are only enough assets to fund two trusts.)

As discussed in §13A.71, the most commonly used formulas in a two-trust division provide, in part, for the following:

- The largest pecuniary amount that can pass free of estate tax without taking into account the marital deduction shall pass to the credit trust, and any remaining assets shall pass to the survivor's trust. This is known as a pecuniary credit/residuary survivor's formula, or, as the authors refer to it for reasons discussed below, the "bad formula."
- The smallest pecuniary amount necessary to reduce the estate tax to zero shall pass to the survivor's trust, and any remaining assets shall pass to the credit trust. This is known as a pecuniary survivor's/residuary credit formula, or, as the authors refer to it for reasons discussed below, the "good formula."

A three-trust division is similar, except that the portion of the decedent's assets passing to the survivor's trust in a two-trust division will pass instead to a marital trust in a three-trust division. The examples will begin with an analysis of what happens when some amount (even one dollar) of the decedent's assets must be funded into the survivor's trust using these formulas in a two-trust division. We will then examine the anomalous result that may occur when the decedent's net estate as of the date of death is less than the decedent's remaining applicable exclusion amount. First, we will consider the result in a three-trust division, and then question whether the result is different in a two-trust division.

Assume the decedent died in 2007 (when the applicable exclusion amount was $2 million) with a share of trust assets equal to $1.8 million, and a pecuniary credit/residuary marital formula. Because the decedent's share is less than the pecuniary amount passing to the credit trust, the marital trust would never come into existence. By definition, all of the decedent's assets must have passed to the credit trust, and no appreciation can be attributed to the marital trust because the marital trust never came into existence. As a result, if the assets have appreciated by $5 million, the entire $6.8 million (*i.e.*, $1.8 million plus $5 million) could be funded into the credit trust.

By contrast, when even one dollar must be allocated to the residuary trust (in this example, the marital trust), all of the appreciation (less interest paid to the pecuniary trust) would also be allocated to the residuary trust. For example, assume the decedent in the previous example owned assets with a date-of-death value of $2.1 million in 2007 (ignoring the effect of deductions) and the assets have appreciated by $5 million. Under these facts, the value of the decedent's assets exceeded the $2 million pecuniary amount passing to the credit trust. Consequently, we can no longer make the claim that the residuary marital trust would not come into existence, because $100,000 was allocable to it as of the date of death. Because we can no longer argue that that appreciation must be attributed entirely to assets of the pecuniary trust by process of elimination, all of the appreciation (less interest paid to the pecuniary trust) must be allocated to the residuary marital trust. In other words, in this example, $2 million (plus interest) would pass to the credit trust, and $5.1 million (less interest) would pass to the marital trust.

This same logic should apply in a two-trust division with a pecuniary credit/residuary survivor's formula. Assuming that the decedent's side of the ledger had a value of $1.8 million in 2007 (when the estate tax applicable exclusion amount was $2 million), a pecuniary credit/residuary survivor's formula would have caused all of the decedent's assets to be funded into the credit trust. Again, this is true because all of the decedent's assets would have passed to the credit trust, and consequently all appreciation must be attributable to those assets by process of elimination. By contrast, when even one dollar must be allocated to the survivor's trust, the premise of this argument no longer holds true. For example, if the decedent died in 2007 with $2.1 million on the decedent's side of the ledger, a pecuniary credit/residuary survivor's formula would cause $100,000 of the decedent's assets ($2,100,000 − $2,000,000) to be allocated to the survivor's trust. Because we can no longer say that any subsequent appreciation must be attributed to the credit trust by process of elimination, all of that appreciation (less interest paid to the credit trust) must be allocated to the survivor's trust.

NOTE: Reasonable minds could differ on this point. In the case of a three-trust division, all of the appreciation stays on the decedent's side of the ledger (in the residuary trust). By contrast, in the two-trust division in the above example, the residuary amount crosses the line between the decedent's side and the survivor's side by going outright to the survivor. This gives rise to at least two arguments. First, it might be asserted that the decedent intended for the appreciation to be allocated entirely to the survivor. Second, unlike the unfunded residuary marital trust in the above example, the survivor's trust will be funded because it will receive the survivor's assets. It may

therefore be argued that the two-trust division fails the "even one dollar" test discussed above, and the residuary amount (including appreciation) must be funded into the survivor's trust, even if the decedent's share of assets is less than the applicable exclusion amount ($1.8 million in the above example). Fortunately, because the "bad formula" is used in only a small percentage of cases, the attorney may only rarely be confronted with this issue in practice. In the authors' opinion, neither of these arguments is persuasive. The primary objective of a stale trust funding is to put the trust in the same position, to the extent possible, as it would have been in had the trust been administered promptly. Putting that aside for the moment, one might question why an attorney would draft in such a way as to make the trust susceptible to dispute on this point. As discussed above, the outcome would be far different if the decedent's share is less than the applicable exclusion amount and the formula provides for a marital trust in addition to a credit trust. If for no other reason than to avoid this potential problem, it is the authors' opinion that drafters should always provide for a three-trust division (*i.e.*, survivor's/credit/marital), even when it is anticipated that there will never be a marital share.

While the above examples assume appreciation of trust assets, depreciation is allocated to the same subtrusts as appreciation. Consequently, in situations where there is a pecuniary formula with date-of-distribution funding, depreciation would reduce the amount allocated to the residuary trust. Where there is a fractional share formula or a pecuniary formula using fairly representative date-of-death (as opposed to date-of-distribution) funding, depreciation would be allocated proportionately between the subtrusts.

It should be noted that the above examples assumed amounts of appreciation allocated equally between the shares of the two spouses. In reality, the picture is much more complicated. The typical credit trust provides for the mandatory payment of income to the surviving spouse. If the surviving spouse uses that income to purchase an appreciating asset, the resulting appreciation should be allocated entirely to the survivor's trust. In other words, it should be treated as though the surviving spouse had received her outright income distribution and then used the money to purchase the asset. Because the income was owned outright by the surviving spouse, the asset purchased should also be traced directly to the surviving spouse.

The result is that none of the appreciation is attributable to the decedent's side of the ledger. By contrast, if it can be shown that the surviving spouse used all of the income of the trust to defray living expenses or for other purposes, or that the new asset was purchased using the proceeds of an asset existing as of the decedent's death, it may be possible to attribute the appreciation to the decedent's side of the ledger. For this reason, tracing the source of funds used to acquire assets following the death of the first spouse can be critical. Although it may not be possible to trace every transaction down to the last dollar, the surviving spouse's income tax returns usually contain a wealth of raw data that can prove invaluable for tracing purposes.

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Court Proceedings

CEB Staff

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.1 I. WHEN PROCEEDINGS MAY BE INITIATED

§15.1 I. WHEN PROCEEDINGS MAY BE INITIATED

In the course of administering a trust, even in the absence of a dispute, court proceedings may be initiated by the trustee or beneficiary, *e.g.,* to seek advance court approval of a proposed action, instructions regarding a trust issue, or court approval of an action already taken. Disputes leading to litigation involving the trustee may arise, *e.g.,* when one of the following occurs:

- Someone questions the validity of the trust.
- The trustee needs an interpretation of trust language.
- The trustee needs a court to determine whether a gift to a caregiver is valid under Prob C §21351(d), which requires the caregiver to prove by clear and convincing evidence that the gift is not the product of fraud or undue influence.
- The trustee is accused of breach of a fiduciary duty.
- The trustee as fiduciary is called on to defend the trust from claims by strangers to the trust.
- It is necessary for the trustee as fiduciary to sue on behalf of the trust.
- A party interested in the trust believes that actions the trustee has taken, or failed to take, have adversely affected the party's interests.
- Litigation is commenced to remove the trustee.

For in-depth coverage of these issues, see California Trust and Probate Litigation (Cal CEB 1999).

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II. JURISDICTION AND VENUE

A. Trusts Under Continuing Court Jurisdiction

§15.2 1. Supervised Versus Unsupervised Trusts

Practitioners have traditionally spoken of "supervised" and "nonsupervised" trusts. This wording also avoids the ambiguities in the word "jurisdiction."

Supervised trusts are testamentary trusts created by a will executed before July 1, 1977, and not incorporated by reference in a will or codicil executed on or after that date, that have not been removed from court supervision, and testamentary trusts with express provisions requiring continuing supervision. See Prob C §§17300-17354. Trustees of supervised trusts must account to the court even if there is no request by a beneficiary.

Testamentary trusts created after June 30, 1977, without express provisions requiring supervision are unsupervised. The court will not be involved in their administration or supervision unless a trustee or beneficiary files a petition under Prob C §17200 seeking the court's involvement.

California Rules of Court 7.903 also refers to court supervision of certain "trusts funded by court order." See §15.2A.

The practical consequences of the distinction between supervised and unsupervised trusts are not great for two reasons. First, with only minor exceptions, any trustee or beneficiary of an unsupervised trust may invoke the court's jurisdiction, *i.e.,* supervision, by filing a petition under Prob C §17200. Of course, this intervention is ad hoc, and once the particular matter has been disposed of, *e.g.,* once instructions on the sale of a trust asset have been issued, supervision usually ceases. Second, trusts can be removed from court supervision.

NOTE: The accounting requirements of supervised trusts other than trusts funded by court order as provided in Cal Rules of Ct 7.903 are specified by local court rules rather than by the Probate Code or the California Rules of Court. Court approval of accounts and reports may not be required for all supervised trusts. The level of supervision of trusts varies from court to court, depending on local rules, procedures, the court's case load, and the needs of individual cases. Trust matters usually do not come to the court's attention unless the trustee or beneficiary files a petition seeking approval of an action or instructions.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.2A 2. Certain Trusts Funded by Court Order

§15.2A 2. Certain Trusts Funded by Court Order

Under Cal Rules of Ct 7.903(b), a court order funding a trust under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons) *must* provide that the trust is subject to the continuing jurisdiction of the court, and *may* provide that the trust is subject to ongoing court supervision. "Continuing jurisdiction" is defined as the court's continuing subject matter jurisdiction over trust proceedings under Division 9 of the Probate Code (Prob C §§15000-19403). Cal Rules of Ct 7.903(a)(2). "Court supervision" means the court's authority to require approval or confirmation of the trustee's actions—as for the actions of a guardian or conservator of the estate under Division 4 of the Probate Code—not supervision under Prob C §§17300-17354, which is the part of the Trust Law governing testamentary trusts subject to continuing court jurisdiction. Cal Rules of Ct 7.903(a)(3).

California Rules of Court 7.903(c) further provides that, unless the court otherwise orders for good cause shown, the trust instrument must:

(1) Not contain a "no contest" provision;

(2) Prohibit modification or revocation without court approval;

(3) Clearly identify the trustee and any other person with authority to direct the trustee to make disbursements;

(4) Prohibit investments by the trustee other than those permitted under Prob C §2574; (guardianship or conservatorship investment requirements);

(5) Require persons identified in (3) to post bond in the amount required under Prob C §§2320-2335;

(6) Require the trustee to file accounts and reports for court approval in the manner and frequency required by Prob C §§1060-1064 and 2620-2628;

(7) Require court approval of changes in trustees and a court order appointing any successor trustee; and

(8) Require compensation of the trustee, the members of any advisory committee, or the attorney for the trustee, to be in just and reasonable amounts that must be fixed and allowed by the court. The instrument may provide for periodic payments of compensation on account subject to the requirements of Prob C §2643 and Cal Rules of Ct 7.755.

For trusts with total assets of $20,000 or less, the requirements of Cal Rules of Ct 7.903(c)(5)-(8) do not apply. Cal Rules of Ct 7.903(d).

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§15.3 3. Removal From Continuing Court Jurisdiction

Removal of a trust from court jurisdiction may be mandatory, if the trustee is a trust company (see §15.3A), and discretionary in other circumstances (see §15.3B). When there is a choice, the trustee should consider the advantages and disadvantages of court supervision. Because many individual trustees neither take fees nor account to the court, instead obtaining waivers of accounting at the termination of the trust, the attorney should discuss with the trustee whether the cost of preparing the full accounting required for removal of the trust from court supervision, and the subsequent annual accountings under Prob C §16062(c), are worth the time and expense to the trust. On the other hand, many trustees value the discipline and the protection obtained from periodic accountings to the court.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.3A a. Mandatory Removal for Trust With Corporate Trustee

§15.3A a. Mandatory Removal for Trust With Corporate Trustee

If the trustee of a trust described in Prob C §17350 is a trust company as defined in Prob C §83, the trustee must petition for removal from continuing court jurisdiction. Prob C §§17300(b), 17351. The procedure to be used by a trust company trustee to terminate court supervision is set out in Probate Code §17351. The same removal procedures are followed when a trust company becomes a successor trustee. The date of appointment is treated as the date of initial funding. Prob C §17353.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.3B b. Discretionary Removal for Trust With Individual Trustee

§15.3B b. Discretionary Removal for Trust With Individual Trustee

Supervised trusts (*i.e.,* testamentary trusts created by a will executed before July 1, 1977, and testamentary trusts that expressly require continuing supervision) that are administered by individual trustees may be removed from continuing court jurisdiction only with approval of the court having jurisdiction of the trust. Prob C §17352(a). A petition for removal may be filed at any time with the court in which the decedent's estate was probated. The requirements for a petition by an individual trustee to terminate court supervision are set out in Prob C §17352(b).

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§15.4 4. Consequences of Removal

A trustee of a trust that has been removed from continuing court jurisdiction under Prob C §§17350-17354 must furnish accountings to the beneficiaries as required by Prob C §16062(a). Prob C §16062(c). Once a trust with a trust company trustee is removed from continuing court jurisdiction, it stays removed even if the successor trustee is an individual. Prob C §17354. The successor must comply with the annual statement requirements even if he or she would not have chosen to do so. Prob C §16062(a).

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B. Subject Matter Jurisdiction

§15.5 1. Reach of Court's Power

The superior court exercises jurisdiction over trust matters on any basis not inconsistent with the state and federal constitutions. Prob C §17004, citing CCP §410.10. Probate Code §17004 was intended to adopt the limitations of CCP §410.30, under which a California court may not exercise jurisdiction if the exercise would constitute an undue interference with the jurisdiction of a court of another state. See Comment to Prob C §17004.

The court's jurisdiction encompasses the following:

- *Trustees.* The court has jurisdiction over trustees who accept the trusteeship of a trust "having its principal place of administration" in California, regardless of the location of trust property or the trustee. Prob C §17003(a). See §15.12. A trustee of a California trust submits to jurisdiction in California by accepting the trusteeship, even though the trustee may be a nonresident. Prob C §17003(a).
- *Beneficiaries.* The court has jurisdiction over beneficiaries of a trust "having its principal place of administration" in California (see §15.12) to the extent of the beneficiaries' interests in the trust. Prob C §17003(b). This is quasi-in-rem jurisdiction. Prob C §17003(b). Beneficiaries are also bound by decisions of a court with jurisdiction if they have proper notice and an opportunity to protect their interest. *Mullane v Central Hanover Bank & Trust Co.* (1950) 339 US 306, 94 L Ed 865, 70 S Ct 652.
- *In rem jurisdiction.* Subject to constitutional limitations and CCP §410.30, the court may exercise in rem jurisdiction over matters involving trust property located in California, even if the trust's principal place of administration is outside California. Prob C §17004. However, the court's in rem jurisdiction does not extend to intangible personal property. See *Hanson v Denckla* (1958) 357 US 235, 246, 2 L Ed 2d 1283, 1295, 78 S Ct 1228. See also *Estate of Radovich* (1957) 48 C2d 116, 120, 308 P2d 14 (court has in rem jurisdiction over probate estate).
- *Jurisdiction over foreign trusts*. Suits may be brought against foreign trusts if any of the trustees or the administration of the trust is in California, subject to the jurisdictional limitations found in CCP §410.10 and federal due process principles. See Prob C §17002.

The probate court retains jurisdiction over a testamentary trust after distribution of the decedent's estate for any purpose specified in Prob C §17200 (see §15.22), either if the testator so provides or if the trust was created by will before July 1, 1977, and not incorporated by reference in a will after June 30, 1977, and has an individual trustee who has not removed the trust from court supervision. Prob C §§17300-17301.

The "probate court," or probate department of the superior court hearing proceedings concerning the internal affairs of trusts, has "all the powers of the superior court." Prob C §17001. There is, therefore, no distinction between the powers of a superior court judge generally and those of a superior court judge in a probate matter. The superior courts, of course, remain free to designate specific departments for probate and trust cases. There is no right to a jury trial concerning the internal affairs of trusts. Prob C §17006. See §15.9.

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§15.6 2. Exclusive Jurisdiction Over Trust's Internal Affairs

The superior court has exclusive jurisdiction of all proceedings concerning the internal affairs of trusts. Prob C §17000(a); *Saks v Damon Raike & Co.* (1992) 7 CA4th 419, 8 CR2d 869. An action by a beneficiary against the trustee for, *e.g.,* breach of trust, conversion, or fraud concerns the internal affairs of the trust and therefore must be heard by the court having jurisdiction over the trust under Prob C §17000(a). For such issues as settling the trustee's accounts, instructing the trustee, compelling the trustee to render an accounting, and any of the other issues relating to the trust's internal affairs, a trustee or beneficiary must bring the action in the probate court having jurisdiction over the trust. The procedures are identical for supervised and unsupervised trusts. Prob C §§17000, 17200, 17301.

It is unclear whether §17000(a) precludes federal court jurisdiction in diversity (see *e.g., Jefferson Nat'l Bank v Central Nat'l Bank* (7th Cir 1983) 700 F2d 1143). For further discussion, see Stravitz & Medlin, *Removal of Probate Cases to Federal Court*, 17 Prob Prac Rep 1, 5 (July 2005). If trust supervision is thus construed as an in rem probate action, there may be no federal jurisdiction, but in most trust cases it would appear that diversity jurisdiction would still be proper. On jurisdiction generally, see California Civil Procedure Before Trial, chap 6 (4th ed Cal CEB 2004). However, except for interpleader actions regarding life insurance, trust cases are rarely filed in federal court.

It has been held under former Prob C §1138.1 that the probate court has jurisdiction over a trust regardless of trust language to the contrary. For example, a trust provision that neither an "original trustee nor any successor trustee shall be subject to the jurisdiction of the court administering the estate" was held ineffective to keep the court from exercising jurisdiction. *Estate of Parrette* (1985) 165 CA3d 157, 211 CR 313.

NOTE: It appears that a superior court sitting in probate also has exclusive jurisdiction over declaratory relief actions concerning wills and trusts. See CCP §1060 (expressly excludes wills and trusts from written instruments with respect to which interested parties may bring original declaratory relief actions); Prob C §17200; *Howard v Bennett* (1942) 53 CA2d 546, 127 P2d 1012 (superior court sitting in probate has exclusive jurisdiction over declaratory relief action to construe terms of will in estate it is administering).

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§15.7 3. Concurrent Jurisdiction

The superior court having jurisdiction over the trust has concurrent jurisdiction with the civil court, rather than exclusive jurisdiction over actions and proceedings (Prob C §17000(b)):

- To determine the existence of trusts;
- By or against creditors or debtors of trusts; or
- Involving trustees and third persons.

This jurisdiction extends to determining the rights of the trust versus third parties in assets of the trust. *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433. Civil actions involving the trustee and strangers to the trust, for example, while they are generally heard in probate court, can be heard by the civil or probate department of any superior court having personal jurisdiction over the parties. Prob C §17000(b)(3). See *Harnedy v Whitty* (2003) 110 CA4th 1333, 2 CR3d 798.

PRACTICE TIP: Probate judges are generally more familiar with trust issues, and probate courts may be more amenable to a speedy resolution of disputes through mediation and more protective of elderly or frail trustees and beneficiaries.

The trustee or any interested person may file a petition under Prob C §850 (petitions under *Heggstad* are now generally captioned as Prob C §850 petitions) requesting that the court issue an order in the following situations:

- When the trustee is in possession of, or holds title to, real or personal property, and the property, or some interest, is claimed to belong to another;
- When the trustee has a claim to real or personal property, title to or possession of which is held by another; or
- When the property of the trust is claimed to be subject to a creditor of the settlor.

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4. When Case May Be Brought as Civil Action or Action Under Trust Law

§15.8 a. Beneficiary's Litigation Strategy

If an action does not concern the trust's internal affairs, or is brought to determine the existence of the trust (Prob C §17000), a beneficiary may choose to initiate a civil action instead of bringing the action under Part 5 of Division 9 of the Probate Code (Prob C §§17000-17457). Such a suit may be more costly and time-consuming than a trust hearing, but for the beneficiary who proceeds against the trustee it has the advantage that the rules of evidence and procedure will be more strictly observed, thus requiring the trustee to be more specific in responses and document production in defense of his or her actions. In *Mota v Superior Court* (2007) 156 CA4th 351, 67 CR3d 303, the court held that a trial court's denial of a petition to compel discovery in a probate matter was erroneous when the party seeking discovery alleged that other trust beneficiaries had misappropriated trust property and should therefore receive reduced distributions from the trust's remaining assets. The court noted that discovery is permitted in matters concerning the internal affairs of a trust under Prob C §1000. The court then held that the plaintiff was not required to file a Prob C §850 proceeding because she was not seeking to have any property transferred to the trust. On the other hand, experienced probate attorneys may not wish to become involved in a civil action, while other trial counsel may be less familiar with trust issues.

A civil suit may be inappropriate, however, due to the delay in obtaining a trial date, particularly in more populous counties. Typically, the probate calendar offers speedier resolution for beneficiaries who do not wish to wait months, or even years, for a civil trial date (although plaintiffs over the age of 70 may be entitled to priority in civil court cases under CCP §36).

NOTE: If the action is intended to establish that the trustee has committed a breach of trust, it concerns the internal affairs of the trust and so must be brought as a trust hearing. Prob C §§17200(b)(12), 17000(a).

In addition to actions over which the superior court has concurrent jurisdiction, a case may present several different bases for litigation, each of which entails a choice of forms of actions and courts. For discussion of considerations when multiple proceedings are possible, see California Trust and Probate Litigation, chap 7 (Cal CEB 1999).

In petition proceedings regarding title to or possession of trust property under Prob C §§850-859, the action may include claims and causes of actions that are normally raised in a civil action to the extent the matters are factually related to the petition. Prob C §855.

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§15.9 b. Right to Jury Trial

In a civil suit, the plaintiff is normally entitled to try issues before a jury. Cal Const art I, §16. However, the remedies of a beneficiary against the trustee for breach of trust are strictly in equity, thus eliminating the right to a jury trial. Prob C §16421. More generally, there is no right to a jury trial in proceedings "concerning the internal affairs" of the trust. Prob C §17006. If the action against the trustee is not for a breach and does not concern the internal affairs of the trust, a jury may be available in civil court but not in probate court.

If a third party defendant is involved, *e.g.,* a person who assists in a breach of trust, the right of the third party to a jury depends on the gist of the action. See *Walton v Walton* (1995) 31 CA4th 277, 291, 36 CR2d 901. The court can empanel an advisory jury (*Estate of Beach* (1975) 15 C3d 623, 125 CR 570), but this procedure seems wasteful. If the party is not entitled to a jury, the appointment of an advisory jury should not be allowed.

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C. Venue

§15.10 1. Proper Venue

The proper venue for a trust proceeding brought under Part 5 of Division 9 of the Probate Code (Prob C §§17000-17457) depends on the type of trust:

- For revocable trusts and irrevocable trusts, the proper jurisdiction is the principal place of administration (see §15.12) for the trust. Prob C §17005(a)(1). If a revocable trust has no trustee, the proper county for commencement of a proceeding for appointing a trustee is the county in which the trust property, or some portion of the trust property, is located. Prob C §17005(b).
- For testamentary trusts not subject to court supervision, the proper venue is either the county in which the will was probated or the county of the principal place of administration of the trust. Prob C §17005(a)(2).
- For testamentary trusts under continuing court supervision, the proper venue is the county in which the will establishing the trust was probated. See Prob C §17301. At any time after final distribution of the decedent's estate, however, the trust may be transferred to a different county in California under the provisions of Prob C §17304.

Certain actions, such as one for the removal of a trustee, can also be brought in the jurisdiction where the trustee resides. See Comment to Prob C §17004. If the plaintiff has an action that would not come under Prob C §17000 and wishes to bring a civil suit, the general rules of venue apply. Prob C §17005. See California Civil Procedure Before Trial, chap 20 (4th ed Cal CEB 2004).

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§15.11 2. Change of Venue

A change of venue may be desirable for several reasons, *e.g.,* the convenience of one or more of the parties, including the trustee; as a litigation strategy because of local court rules; or for convenience due to the location of witnesses or documents or the state of the local docket. Note that, if there are several trustees, venue is proper at the place of residence or usual place of business of any of them, absent their agreement. Prob C §17002(b)(2). See *San Francisco Found. v Superior Court* (1984) 37 C3d 285, 294, 208 CR 31, for a discussion of factors justifying change of venue.

The requirements for a petition for a change of venue of a testamentary trust under continuing court jurisdiction are specified in Prob C §17304. If, after the hearing, it appears to the court that the transfer will be in the trust estate's best interest or that it will facilitate economical and convenient administration of the trust, the court must order the transfer. Prob C §17304(c).

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§15.12 D. Principal Place of Administration

The principal place of administration of a trust is generally where the trust's day-to-day activity is carried on by the trustee or its representative. Prob C §17002(a). If that place cannot be determined, the principal place is the trustee's residence or place of business. Prob C §17002(b). If an out-of-state trustee accepts the trusteeship with plans to administer the trust in his or her home state, the California court would not be able to assert jurisdiction as provided for trusts administered in this state under Prob C §17003, without the agreement of the trustee and beneficiaries, except, of course, over property located in California. Once the court has acquired jurisdiction over the parties, jurisdiction continues until the proceeding is concluded, even if the trust property is removed from the state.

NOTE: A petition may be filed to transfer the place of administration of a trust, or some or all of the trust property, to another state. Prob C §§17400-17405. A court may also make an order accepting the transfer of place of administration of a trust to California or the transfer of some or all of the trust property in another jurisdiction to a trustee in California. Prob C §§17450-17457.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/ III. PARTIES IN LITIGATION/§15.13 A. Who Can Sue or Be Sued

III. PARTIES IN LITIGATION

§15.13 A. Who Can Sue or Be Sued

In any type of litigation, the trustee, not the trust itself, is the proper party for an action, either as plaintiff or defendant, because the trust may not sue or be sued in its own name. See Prob C §§16249(a), 18004; *Saks v Damon Raike & Co.* (1992) 7 CA4th 419, 8 CR2d 869. The trustee holds title to the assets and is the real party in interest. A trustee cannot represent the trust in propria persona against a third party. *Ziegler v Nickel* (1998) 64 CA4th 545, 75 CR2d 312. However, at least one court has held that a trustee may bring a petition for orders terminating the trust, settling accounts, and awarding attorney fees. *Finkbeiner v Gavid* (2006) 136 CA4th 1417, 39 CR3d 871.

NOTE: See §15.23 for discussion of who has standing to bring a petition under Prob C §17200.

The settlor of a trust, in that capacity, does not have standing either to sue the trustee or to sue third parties on behalf of the trust, but may have standing as a beneficiary. For these purposes, the settlor of a charitable trust may be considered a beneficiary even if the settlor does not have a reversionary interest in the trust if the settlor retains certain powers to enforce the trust, such as the power to object to a trustee accounting. Prob C §24(d); *Patton v Sherwood* (2007) 152 CA4th 339, 61 CR3d 289; *L.B. Research & Educ. Found. v UCLA Found.* (2005) 130 CA4th 171, 29 CR3d 710. Beneficiaries do not have standing to bring suit in civil court against third parties regarding the internal affairs of the trust. *Saks v Damon Raike & Co., supra*.

Generally, the proper party to bring a suit against a third party for damages to trust property is the trustee. The beneficiary can only bring such a suit if the trustee improperly refuses to do so, or the trustee cannot be subject to the jurisdiction of the court, or there is a vacancy in the office of trustee, or the trustee breached the trust by participating in the transaction with the third party. When the last exception applies, the beneficiary may sue the trustee, the third party, or both. *Harnedy v Whitty* (2003) 110 CA4th 1333, 1341, 2 CR3d 798. See *Estate of Bowles* (2008) 169 CA4th 684, 87 CR3d 122. See also *King v Johnston* (2009) 178 CA4th 1488, ___ CR3d ___, in which the court held that the beneficiary may sue the third party who participated in the breach of trust even after a successor trustee has been appointed. Further, if a person who is not in fact a trustee acts as such, whether by mistake or intentionally, that person becomes a trustee *de son tort* and will be subject to the same rules and remedies as a trustee. 178 CA4th at 1504.

Beneficiaries have standing and must be joined either when the litigation involves their interests or when the trustee fails to protect the beneficiaries' interests. *Lake v Dowd* (1929) 207 C 290, 277 P 1047. As an example, the beneficiaries must be joined when there is a challenge to the dispositive provisions of the entire trust, but if the challenge relates only to the share of one beneficiary, there is no need to join the others. See §15.14 on indispensable parties.

Although the trustee is usually the proper party to bring an action on behalf of the trust, in *Pearce v Superior Court* (1983) 149 CA3d 1058, 197 CR 238, a beneficiary was permitted to bring a derivative action on behalf of the corporation under Corp C §800(b) when the trustee as shareholder refused to do so. In addition, if the litigation is basically a dispute between competing trust beneficiaries, the trustee's attorney may not be entitled to fees even when the court holds that the trustee has a duty to prevent entry of a default judgment. *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742.

Beneficiaries of a trust may use a class action to represent all beneficiaries of the trust in an action against the trustee. *Hebbard v Colgrove* (1972) 28 CA3d 1017, 105 CR 172. However, from a practical standpoint, class actions, with their attendant additional legal steps (such as proving the plaintiff is a proper class representative and certifying the class) are rarely used. The vast majority of trusts have a sufficiently small group of beneficiaries for all beneficiaries to sue as individual plaintiffs.

The trustee is under a duty to the beneficiaries to take reasonable steps to enforce any claims that he or she holds as trustee. Restatement (Third) of Trusts §76, Comment d (2007); Restatement (Second) of Trusts §177, Comment a (1959). Beneficiaries also have standing when the trustee fails to protect the beneficiaries' interests. *Triplett v Williams* (1969) 269 CA2d 135, 74 CR 594. The beneficiary must establish that the trustee's failure to act was negligent,

wrongful, or otherwise improper. *Pillsbury v Karmgard* (1994) 22 CA4th 743, 27 CR2d 491. See Restatement (Second) of Trusts §282 (1959). See also *Saks v Damon Raike & Co.* (1992) 7 CA4th 419, 427, 8 CR2d 869:

> [W]here a trustee cannot or will not enforce a valid cause of action that the trustee ought to bring against a third person, a trust beneficiary may seek judicial compulsion against the trustee. In order to prevent loss of or prejudice to a claim, the beneficiary may bring an action in equity joining the third person and the trustee.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.14 B. Indispensable Parties

§15.14 B. Indispensable Parties

During the early stages of trust litigation, the attorney must determine which parties are indispensable and which parties are merely desirable to include in the case. The trustee is an indispensable party in any action involving the trust or trust assets. CCP §389(a); *Bank of Cal. v Superior Court* (1940) 16 C2d 516, 106 P2d 879.

Whether all beneficiaries are indispensable depends on the nature of the action. The beneficiary is an indispensable party when his or her share of the principal or income is affected by the proceeding. *Auslen v Superior Court* (1962) 58 C2d 820, 27 CR 8; *Estate of Reed* (1968) 259 CA2d 14, 21, 66 CR 193. If one of several beneficiaries with undetermined interests in a trust acts adversely to the others by seeking to recover the whole or a portion of the trust corpus or to fix his or her share, all beneficiaries are indispensable. *Hebbard v Colgrove* (1972) 28 CA3d 1017, 1026, 105 CR 172, 177. See also *Estate of Reed* (1968) 259 CA2d 14, 66 CR 193.

Beneficiaries whose interests are *not* affected by the proceeding include, *e.g.,* income beneficiaries when the proceeding affects only the distribution of the remainder and remainder beneficiaries when the dispute is merely between rival claimants. In an action to compel an accounting, to appoint a receiver, for breach of trust, to remove a trustee, or to impress a trust on property purchased with trust assets, not all beneficiaries must be named in the action. *Bowles v Superior Court* (1955) 44 C2d 574, 283 P2d 704; *Copley v Copley* (1981) 126 CA3d 248, 297, 178 CR 842; *Estate of Hensel* (1956) 144 CA2d 429, 301 P2d 105. Further, if a beneficiary sues only on behalf of himself or herself, for an award pertaining only to his or her own interest, other beneficiaries need not be joined, unless somehow their interests will be tangentially affected by the judgment.

The attorney representing a trustee sued by one or more beneficiaries must always be sure that all indispensable parties have been joined. Joinder will protect the trustee from multiple suits by other beneficiaries, particularly if the suit by one beneficiary over his or her interest may apply to other beneficiaries. See *Hebbard v Colgrove* (1972) 28 CA3d 1017, 1026, 105 CR 172. Failure to join an indispensable party divests the court of jurisdiction over that party and may make the proceedings voidable. *Copley v Copley* (1978) 80 CA3d 97, 109, 145 CR 437. If it is absolutely clear, however, that a party is not indispensable, counsel should consider minimizing the complexity of the case by not joining the party.

NOTE: All beneficiaries generally must receive notice of the proceeding and may then decide the extent to which they wish to participate, but this does not join them. Joinder occurs only upon a party being named and served in the lawsuit. See CCP §389. The California Attorney General must also be given notice when a charitable trust is involved in the action. Prob C §17203(a)(3).

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§15.15 C. Parties Under Disability; Unknown Parties

If any beneficiaries are minors or under legal incapacity, they must be represented in a court proceeding if their interests are affected. An adult under conservatorship is normally represented by a conservator, and a minor beneficiary may be represented formally by a guardian. Prob C §2462. A power of attorney for financial management may grant to the agent the power to similarly represent the principal. See Prob C §4263(a)(2).

In many cases, minor beneficiaries or unascertained beneficiaries (those as yet unborn or otherwise unknown) may be represented in a suit by a guardian ad litem. See Prob C §1003. If a guardian for a minor has been appointed by the court (see Prob C §2462), a guardian ad litem is usually unnecessary but may still be appointed if needed, *e.g.,* if the guardian has a conflict. For discussion and forms for appointment of guardians ad litem, see §§15.16-15.21.

NOTE: There is no case law concerning the validity of orders affecting a beneficiary when no guardian ad litem is appointed. In *Estate of Lacy* (1975) 54 CA3d 172, 126 CR 432, however, the court found an order void for, among other things, failure to give notice to remainder beneficiaries who were represented by a guardian ad litem whose interests conflicted with theirs.

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§15.16 D. Guardians ad Litem

In the context of trust administration, a guardian ad litem is a court appointee who represents the interests of minors, incapacitated, unborn, or unascertained persons, persons whose identity or address is unknown, or a designated class of persons who are not ascertained or are not in being. See §15.15. On who can be appointed, see §15.17. On appointment procedure, see §15.18. On termination of the appointment, see §15.20. On compensation of the guardian ad litem, see §15.21.

In trust practice, the guardian ad litem is usually appointed for nonadversarial purposes, *e.g.,* in connection with petitions for instruction or distribution. Under Prob C §1003, the appointment is made only "if the court determines that representation of the interest otherwise would be inadequate."

NOTE: It is important to remember that the minor, incapacitated, unborn, or unascertained person is the party and the action should be brought or defended in his or her name and not that of the guardian ad litem. The guardian appears only as a representative. *Estate of Cochems* (1952) 110 CA2d 27, 242 P2d 56. Failure to name the ward as a party may require that the action be dismissed for failure to join a necessary party. See, *e.g., Loock v Pioneer Title Ins. & Trust Co.* (1935) 4 CA2d 245, 40 P2d 526.

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§15.17 1. Who Can Be Appointed Guardian ad Litem

Probate Code §1003(a) gives the court the power to appoint a guardian ad litem on its own motion as well as at the request of a trustee or other interested party. The appointment may be made at any stage of the proceeding.

The Probate Code does not provide guidelines for who can be a guardian ad litem. Probate Code §1003(b) permits the appointment of one person to represent several persons or interests in the same action "[i]f not precluded by a conflict of interest." In practice, the attorney petitions for appointment of a certain person as a guardian ad litem and the court routinely grants orders approving petitions for appointment of a parent or other relative, attorney, or other named adult as a guardian ad litem. Because the guardian's primary duty is to represent the party in matters affecting the trust, the person named in the petition should have sufficient ability, experience, time, and interest to do the job successfully.

Often, a parent or relative is the logical choice unless a conflict of interest exists. A common conflict occurs when a parent is a life tenant and a minor is a remainder beneficiary. See, *e.g., Estate of Lacy* (1975) 54 CA3d 172, 184, 126 CR 432.

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§15.18 2. Appointment Procedure

Probate Code §1003 describes no specific procedure for the appointment of a guardian ad litem. Although CCP §§373 and 373.5 contain numerous specific procedures, the California Law Revision Commission Comment to Prob C §1003 states that these are inapplicable. Use of Judicial Council Form DE-350/GC-100 (Petition for Appointment of Guardian ad Litem—Probate) and Form DE-351 (Order Appointing Guardian ad Litem—Probate) is mandatory. See §§15.19-15.19A. The petition may be submitted ex parte if the box after the title is checked. The proposed guardian ad litem must sign a consent on page 2 of the petition.

If the person for whom appointment is sought is a minor 12 years of age or older who consents to the appointment, the minor may sign the form where indicated. If the person for whom appointment is sought is incompetent to act but is capable of giving consent intelligently, it is good practice to have him or her give written consent for the guardian to act. See *Sarracino v Superior Court* (1974) 13 C3d 1, 118 CR 21.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.19 3. Form: Petition for Appointment of Guardian ad Litem--Probate (Judicial Council Form DE-350/GC-100)

§15.19 3. Form: Petition for Appointment of Guardian ad Litem—Probate (Judicial Council Form DE-350/GC-100)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, State Bar number, and address)*:	*FOR COURT USE ONLY*
TELEPHONE NO.: FAX NO. *(Optional)*: E-MAIL ADDRESS *(Optional)*: ATTORNEY FOR *(Name)*:	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
ESTATE OF *(Name)*: ☐ DECEDENT ☐ CONSERVATEE ☐ MINOR	
PETITION FOR APPOINTMENT OF GUARDIAN AD LITEM—PROBATE ☐ **EX PARTE**	CASE NUMBER:

NOTE: *This form is for use in proceedings under the Probate Code, except a request for court approval of (1) the compromise of a minor's disputed claim, (2) the compromise of an action to which a minor or a person with a disability is a party, or (3) disposition of the proceeds of a judgment in favor of a minor or person with a disability. (See Prob. Code, §§ 3600–3613.) A person seeking the appointment of a guardian ad litem in a civil proceeding should use form CIV-010. A person seeking the appointment of a guardian ad litem in a family law proceeding should use form FL-935. A person may not act as a guardian ad litem unless he or she is an attorney or is represented by an attorney. A guardian ad litem is NOT the same as a guardian of the person or estate of a minor.*

1. Petitioner *(name)*: is
   a. ☐ personal representative of the estate of:
   b. ☐ guardian of:
   c. ☐ conservator of:
   d. ☐ trustee of:
   e. ☐ other interested person *(specify capacity)*:
2. This petition seeks the appointment of the following person as guardian ad litem *(state name, address, and telephone number)*:
3. The guardian ad litem is to represent the interests of the following person *(state name, address, and telephone number)*:
4. The person to be represented is
   a. ☐ a minor *(date of birth)*:
   b. ☐ a person with a disability (within the meaning of Prob. Code, § 3603).
   c. ☐ an unborn person.
   d. ☐ an unascertained person.
   e. ☐ a person whose identity or address is unknown.
   f. ☐ a designated class of persons who are not ascertained or are not in being.
5. Appointment of a guardian ad litem arises out of issues regarding
   a. ☐ the execution of a disclaimer under Probate Code section 277 *(specify details in Attachment 5a)*.
   b. ☐ the representation of the interests of a spouse alleged to lack legal capacity (Probate Code, §§ 3112 and 3140) *(specify details in Attachment 5b)*.
   c. ☐ the consent to modification or termination of trust (Probate Code, § 15405) *(specify details in Attachment 5c)*.
   d. ☐ the approval and settlement of claims against a deceased settlor (Probate Code, § 19029) *(specify details in Attachment 5d)*.
   e. ☐ the representation of a minor, incapacitated person, or other person identified in Probate Code section 1003(a) in a proceeding under the Probate Code (Probate Code, § 1003(a)) *(specify details in Attachment 5e)*.
   f. ☐ other *(specify in Attachment 5f)*.

Form Adopted for Mandatory Use
Judicial Council of California
DE-350/GC-100 [Rev. January 1, 2008]

PETITION FOR APPOINTMENT OF GUARDIAN AD LITEM—PROBATE
(Probate—Decedent's Estates, and Guardianships and Conservatorships)

Print

ESTATE OF *(Name)*: ☐ DECEDENT ☐ CONSERVATEE ☐ MINOR	CASE NUMBER:

6. The appointment of a guardian ad litem is
   a. ☐ proper because the minor has no guardian of his or her estate.
   b. ☐ necessary for the following reasons *(specify reasons. Continue in Attachment 6b if necessary):*

7. The proposed guardian ad litem's relationship to the person he or she is representing is
   a. ☐ related *(state relationship):*
   b. ☐ not related *(specify capacity):*

8. The proposed guardian ad litem is fully competent and qualified to understand and protect the rights of the person he or she is representing as explained in Attachment 8 and has no interest adverse to the interests of that person.

9. Notice of this proceeding
   a. ☐ will be given to the parties named in Attachment 9a.
   b. ☐ should be dispensed with for the following reasons *(specify reasons for ex parte request. Continue in Attachment 9b if necessary):*

10. Number of pages attached: _____

Date:

(TYPE OR PRINT NAME) ▶ (SIGNATURE OF ATTORNEY)

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:

(TYPE OR PRINT NAME) ▶ (SIGNATURE OF PETITIONER)

CONSENT TO ACT AS GUARDIAN AD LITEM

I consent to the appointment as guardian ad litem and I declare under penalty of perjury under the laws of the State of California that the foregoing petition is true and correct.

Date:

(TYPE OR PRINT NAME) ▶ (SIGNATURE OF PROPOSED GUARDIAN)

☐ CONSENT OF MINOR 12 YEARS OF AGE OR OLDER *(Optional)*

I, *(name):* , am *(specify age):* years of age and hereby nominate *(name):* to be my guardian ad litem to represent my interests for the reasons set forth in items 5 and 6 of this petition.

Date:

(TYPE OR PRINT NAME) ▶ (SIGNATURE OF MINOR 12 YEARS OF AGE OR OLDER)

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.19A 4. Form: Order Appointing Guardian ad Litem--Probate (Judicial Council Form DE-351)

§15.19A 4. Form: Order Appointing Guardian ad Litem—Probate (Judicial Council Form DE-351)



ATTORNEY OR PARTY WITHOUT ATTORNEY *(Name, State Bar number, and address):*	*FOR COURT USE ONLY*
TELEPHONE NO.: FAX NO. *(Optional):* E-MAIL ADDRESS *(Optional):* ATTORNEY FOR *(Name):*	
SUPERIOR COURT OF CALIFORNIA, COUNTY OF STREET ADDRESS: MAILING ADDRESS: CITY AND ZIP CODE: BRANCH NAME:	
ESTATE OF *(Name):* ☐ DECEDENT ☐ CONSERVATEE ☐ MINOR	
ORDER APPOINTING GUARDIAN AD LITEM—PROBATE ☐ **EX PARTE**	CASE NUMBER:
	HEARING DATE:
	DEPT.: TIME:

1. The petition for the appointment of a guardian ad litem for *(name):*
   - a. ☐ a minor *(date of birth):*
   - b. ☐ an incapacitated person
   - c. ☐ an unborn person
   - d. ☐ an unascertained person
   - e. ☐ a person whose identity or address is unknown
   - f. ☐ a designated class of persons who are not ascertained or are not in being

   came on regularly for hearing as follows:
   - g. Judge *(name):*
   - h. Hearing date: Time: ☐ Dept.: ☐ Room:
   - i. The following persons were present at the hearing:
     - (1) ☐ Petitioner *(name):*
     - (2) ☐ Attorney for petitioner *(name):*
     - (3) ☐ Guardian ad litem named in item 4.
     - (4) ☐ Attorney for guardian ad litem *(name):*
     - (5) ☐ Person named in item 1.
     - (6) ☐ Other *(name):*

THE COURT FINDS

2. a. ☐ All notices required by law have been given.
   b. ☐ Notice is dispensed with.
3. It is reasonable and necessary to appoint a guardian ad litem for the person named in item 1.

THE COURT ORDERS

4. *(Name):*
   is hereby appointed guardian ad litem of *(name):*
   for the purposes set forth in items 5 and 6 of the petition.
5. The guardian ad litem ☐ is ☐ is NOT authorized to waive or disclaim any substantive rights of the represented party without further order of this court.
6. ☐ Other *(specify. Continue on Attachment 6 if necessary):*

7. ☐ Number of pages attached: _____

Date:

JUDGE OF THE SUPERIOR COURT

☐ SIGNATURE FOLLOWS LAST ATTACHMENT

Form Adopted for Mandatory Use
Judicial Council of California
DE-351/GC-101 [New January 1, 2004]

ORDER APPOINTING GUARDIAN AD LITEM—PROBATE

Probate Code, § 1003

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§15.20 5. Termination of Appointment

When the trust terminates or the litigation ends, the duties of the guardian ad litem are terminated. The duties do not include collection of funds, or custody of money or property of the ward. These duties are performed by a general guardian, whom the court may appoint specifically for this purpose (Prob C §1510) or by a custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925). The Probate Code contains no specific provisions for termination, but the court can presumably terminate or change the appointment at any time.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.21 6. Compensation of Guardian ad Litem

§15.21 6. Compensation of Guardian ad Litem

The court determines reasonable expenses of the guardian ad litem, including compensation and attorney fees, and orders how they are to be paid, either out of the property of the estate involved or by the petitioner or from such other source as the court orders. Prob C §1003(c).

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IV. TRUST BENEFICIARIES AND NOTICE PROVISIONS

§15.21A A. Chart: Trust Beneficiaries

Authority	*Parties Treated as Beneficiaries*
Prob C §24	Definition of "beneficiary" for trust means a person who has any present or future interest, vested or contingent; for charitable trust, includes any person entitled to enforce the trust.
Prob C §§15800-15802	For revocable trust, person holding power to revoke, and not the beneficiary: (a) has the rights of beneficiaries under Division 9, Trust Law (Prob C §§15000-19403); and (b) can consent to an act when consent is permitted or required, except if statute requires joint consent of settlor and all beneficiaries.
Prob C §15803	Holder of a *presently exercisable* general power of appointment or power to withdraw property from trust has rights of a person holding power to revoke a trust as provided in Prob C §§15800-15802, *i.e.,* is treated as beneficiary when notice to beneficiaries is required.
Prob C §15804	Holders of future interests considered beneficiaries when notice to beneficiaries required (see §7.65C): (a)(1) If interest limited upon future contingency to a class of persons, notice given to persons now in being as if contingency occurred now; (a)(2) If interest limited to living person, and upon contingency to surviving spouse or heirs, then notice given to living person; (a)(3) If interest limited to person or class upon happening of future event, and further upon happening of an additional event, then notice to persons who would take interest if first event occurred now. (b) If any conflict between persons to whom notice is required and person not required, notice to both.
Cal Rules of Ct 7.902	All petitions and accounts involving a trust must state names and addresses of all vested or contingent beneficiaries, including all persons in being who may or will receive income or corpus of the trust except for (1) revocable trust, and (2) persons who under Prob C §15804 (future interests) need not be given notice.

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§15.21B B. Chart: Notice Provisions

Authority	*Notice Provisions*
Prob C §851(a), (b)	See §§15.40E-15.40F.
Prob C §17203	See §§15.40C-15.40D.
Prob C §1003	Guardian ad litem. See §§15.16-15.21.
Cal Rules of Ct 7.51	Notice by mail under Prob C §1220 (applies to trusts per Prob C §17100) must be sent: (a) Individually to each person, with separate envelopes to different individuals in same household; notice "in care of" insufficient. (b) To person and attorney if person entitled to notice is represented by attorney; (c) To guardian or conservator if one has been appointed for person entitled to notice; plus another copy to ward or conservatee (unless court dispenses); (d) To minor (unless minor is under 12 and court makes findings per Prob C §1460.1); plus another copy to person(s) with legal custody, with whom minor resides; (e) To personal representative of beneficiary of decedent's estate if that beneficiary also has died.
Cal Rules of Ct 7.53	(a) Amended or amendment to pleading requires same notice as original (including publication); (b) Supplement to a pleading does not require additional notice, but a copy must be served if original notice required service of a copy of the pleading.
Prob C §1201	No need to give notice to oneself, including persons who join in the petition.
Prob C §1202	Court may require additional notice, including longer period of notice.
Prob C §1203	Court may shorten time for mailing notice (unless prohibited by a particular provision), but may not shorten time for publication of notice (unless authorized by particular provision governing publication).
Prob C §1204	A person may waive notice in writing.
Prob C §1205	If hearing continued or postponed, no further notice is required unless ordered by the court.
Prob C §1206	If notice required to heirs or devisees as follows: (a)(1) If intestate, to heirs as named in petition for letters of administration and other heirs who have become known; (a)(2) If testate, to devisees named in petition for probate and other devisees who have become known; (b) Notice not required if person's interest has been satisfied (as evidenced by court order or written receipt).
Prob C §1207	Include notice to persons if reasonable basis for parent-child relationship under Prob C §6454.

Prob C §1208	If no trustee, or trustee and personal representative are the same (but not if there are other cotrustees), notice to trust beneficiaries.
Prob C §1212; Cal Rules of Ct 7.52	If recipient's address is unknown, file declaration under Cal Rules of Ct 7.52(a); court may prescribe or dispense with notice under Cal Rules of Ct 7.52(c), Prob C §1212, and CCP §413.30.
Prob C §1213	To a surety who has filed court bond if petition to surcharge, or if objection to account.
Prob C §1214	If person noticed is also represented by an attorney of record, notice shall *also* be mailed to attorney.
Prob C §1215	Mailing by first class, certified, or express mail if within U.S.; airmail if outside U.S.; mailing completed upon deposit (without extending time for notice).
Prob C §1216	In lieu of mailing, notice may be personally delivered to the person to receive it.
Prob C §1217	If manner of service is not specified in Probate Code, then notice is to be mailed or personally delivered.
Prob C §17105	Notice may be optionally given to anyone without court order.
Cal Rules of Ct 2.306	Fax filing and service: May serve by fax if previous written agreement to accept service by fax; completed at time of transmission but extends period of notice by 2 days.
Cal Rules of Ct 2.260	Electronic filing and service: May serve electronically if previous written agreement to accept service electronically; completed at time of transmission but extends period of notice by 2 days.
Cal Rules of Ct 7.55	Ex parte application must allege whether special notice has been requested; identify; and serve them or obtain waivers.
Prob C §§1260-1265	Provisions re proof of giving notice.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.22 V. PETITIONS UNDER PROB C §17200 OR §850

§15.22 V. PETITIONS UNDER PROB C §17200 OR §850

The superior court having jurisdiction over the trust has exclusive jurisdiction over matters involving the trust's internal affairs. Prob C §17000(a). Probate Code §17200 sets out a nonexclusive list of matters that concern the trust's internal affairs (see §15.23A) and provides that a trustee or beneficiary of a trust may petition the court for any of the purposes listed or to determine the existence of the trust.

The superior court having jurisdiction over the trust has concurrent jurisdiction over the matters set out in Prob C §17000(b): actions and proceedings to determine the existence of trusts, matters involving creditors or debtors of trusts, and other actions and proceedings involving trustees and third persons. The procedure for bringing a petition under Prob C §17200 is governed by the provisions of Prob C §§17200-17211.

Probate Code §§850-859 provide a single procedure for the trial of all property questions and related civil claims within the probate court's jurisdiction, whether the estate concerned is that of a trust, decedent, ward, or conservatee.

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§15.23 A. Standing to File Petition

Only a trustee or beneficiary of a trust may bring a Prob C §17200 petition. A trustee or any interested person may file a petition under Prob C §850(a)(3). An "interested person" is broadly defined as

- An heir, devisee, child, spouse, creditor, beneficiary, or any other person having a property right in, or claim against, a trust estate or decedent's estate that may be affected by the proceeding;
- Any person having priority for appointment as personal representative; or
- A fiduciary representing an interested person. Prob C §48(a).

The meaning of "interested person" as it relates to particular persons may vary, however, and must be determined according to the particular purposes of, and matter involved in, any proceeding. Prob C §48(b). A testamentary trustee, for example, is not an interested person for purposes of contesting a subsequent testamentary document that does not impair a beneficiary's pecuniary interest. *Estate of Getty* (1978) 85 CA3d 755, 149 CR 656. The child of a deceased named trustee of a charitable trust is not an interested person for purposes of petitioning for appointment of a successor trustee. The Attorney General is the only party with standing to represent the trust's intended beneficiaries. *Arman v Bank of America* (1999) 74 CA4th 697, 705, 88 CR2d 410.

A creditor of a trust or of a deceased settlor of a trust that became irrevocable on the trustor's death is an interested person for purposes of requesting special notice of certain proceedings under Prob C §17200. Prob C §17204(b). This does not, however, confer standing on an interested person if standing does not otherwise exist. Prob C §17204(b)(4).

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.23A B. Grounds for Prob C §17200 Petition

§15.23A B. Grounds for Prob C §17200 Petition

Probate Code §17200(b) sets out a nonexclusive list of matters that may be the subject of a petition under the statute, including:

- Determining questions of construction of a trust instrument;
- Determining the existence or nonexistence of any immunity, power, privilege, duty, or right;
- Determining the validity of a trust provision;
- Ascertaining beneficiaries and determining to whom property shall pass on termination of the trust, to the extent not specified in the instrument;
- Settling accounts and passing on the trustee's acts, including the exercise of discretionary powers;
- Instructing the trustee;
- Compelling the trustee to submit a report or account to the beneficiary under specified circumstances;
- Granting powers to the trustee;
- Fixing or allowing payment of the trustee's compensation or reviewing its reasonableness;
- Appointing or removing a trustee;
- Accepting the resignation of a trustee;
- Compelling redress of a breach of the trust;
- Modifying or terminating the trust;
- Combining or dividing trusts;
- Amending the trust to qualify a decedent's estate for the federal estate tax charitable deduction;
- Transferring a trust or trust property between jurisdictions;
- Transferring a supervised testamentary trust between counties;
- Removing a testamentary trust from court supervision;
- Excusing compliance with the governing instrument of an organization under Prob C §16105;
- Determining the trust's liability for a deceased settlor's debts (but this does not confer standing to bring an action under Prob C §17200 on a person whose only claim to trust assets is as a creditor);
- Determining petitions under Prob C §15687 (rules regarding dual compensation to attorney, who also acts as trustee, for legal services rendered to the trust) and reviewing the reasonableness of compensation for legal services under that section; and
- Appointing a practice administrator for a deceased or disabled member of the State Bar under Prob C §9764 or §2468.

Some of the most common matters that are the subject of court proceedings under a Prob C §17200 petition are discussed in §§15.24-15.39.

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§15.24 1. Determining Validity of Entire Trust

Most broad-based attacks on trust instruments may be brought in either the civil department or the probate department because they challenge the validity of the entire trust. Prob C §17000(b)(1). If brought in the probate court, the matter is brought as a Prob C §17200 petition. Prob C §17200(a). Usually a case will be brought to trial faster in the probate department than in the civil department. This can be either a tactical advantage or disadvantage, depending on the circumstances of the case.

PRACTICE TIP: Before deciding to proceed in the probate department rather than the civil department, counsel should determine whether the county's local rules and calendaring practices will permit adequate time for discovery and any motions that are contemplated. Probate judges in some counties allow the parties ample time to carry out discovery and motion practice under the loose supervision of the probate department. In other counties, probate judges immediately assign contested matters to the master trial calendar, bypassing the comparatively slower process of the civil department and causing early discovery cutoffs. Consider that probate judges may be more protective of elderly or frail trustees and beneficiaries and more familiar with trust issues. Also consider whether the probate court in the county where the action will be heard assigns all contested probate court cases to mediation.

The elements required to create a valid trust are:

- A proper manifestation of the settlor's intention to create a trust (Prob C §15201);
- Trust property (Prob C §15202);
- A valid trust purpose (Prob C §15203); and
- A beneficiary (Prob C §15205).

A trust funded with real property is not valid unless it is evidenced by a written instrument (Prob C §15206), but a trust funded only with personal property may be created orally on "clear and convincing evidence.… The oral declaration of the settlor, standing alone, is not sufficient…." Prob C §15207. See also *Selected 1986 Trust and Probate Legislation*, 18 Cal L Rev'n Comm'n Reports 1201, 1328 (Comment to §15207) (1986) (circumstantial evidence of oral trust is insufficient without corroboration in the form of a transfer, earmarking of trust property, or some other written evidence).

In litigation involving the validity of trusts, a first concern should be to determine whether the required elements are present by reviewing the terms of the trust and the circumstances of its creation and execution. If the governing instrument contains an unusual disposition or evidence of suspicious conduct by a beneficiary or attorney toward the settlor, the issue of the validity of the instrument should be considered.

If the settlor was not competent at the time the trust was created, the trust can be rescinded. *Walton v Bank of Cal.* (1963) 218 CA2d 527, 541, 32 CR 856; Restatement (Third) of Trusts §11, Comment e (2003). A settlor who has been induced by fraud to create a trust can rescind the transaction. 1 Scott & Ascher on Trusts §4.6.1 (5th ed 2006). A trust may be rescinded or set aside to the extent it was created as a result of undue influence or duress. See Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2008). A trust agreement may be terminated or reformed if it has been created on the basis of the settlor's substantial mistake of law or fact. If the settlor has received no consideration for the creation of an irrevocable trust by a trust agreement, the trust can be rescinded or reformed on the basis of a mistake to the same extent that an outright gift can be rescinded or reformed. *Walton v Bank of Cal., supra*.

When the settlor or successors in interest seek to rescind the trust on the ground that the settlor was induced to create it by undue influence or by mistake, it is the trustee's duty to defend the trust and resist the proceeding to the extent it is reasonable to do so. Prob C §16011; *Estate of Duffill* (1922) 188 C 536, 554, 206 P 42; *Webb v St. Louis Co. Nat'l Bank* (Mo App 1977) 551 SW2d 869, 882; 3 Scott & Ascher on Trusts §17.10 (5th ed 2007); Restatement (Third) of Trusts §76 (2007); Restatement (Second) of Trusts §178 (1959). But see *Whittlesey v Aiello* (2002) 104

CA4th 1221, 128 CR2d 742 (if the litigation is basically a dispute between competing trust beneficiaries, the trustee's attorney may not be entitled to fees even when the court holds that the trustee has a duty to prevent entry of a default judgment). See also *David v Hermann* (2005) 129 CA4th 672, 28 CR3d 622 (no award of attorney fees to successful challenger of trust held invalid on grounds of undue influence and fraud).

For full discussion and sample forms, see California Trust and Probate Litigation, chaps 6, 20 (Cal CEB 1999).

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§15.25 2. Determining Validity of a Trust Provision

If an action is one to challenge the validity of the entire instrument, the probate court has concurrent jurisdiction under Prob C §17000(b). See §15.24. The probate court has exclusive jurisdiction under Prob C §17000(a), however, if the trust is challenged under Prob C §17200(a) without attacking the validity of the entire instrument. Examples include actions to:

- Determine questions of construction of the trust instrument (Prob C §17200(b)(1));
- Determine the existence or nonexistence of any immunity, power, privilege, duty, or right (Prob C §17200(b)(2));
- Determine the validity of a trust provision (Prob C §17200(b)(3));
- Ascertain beneficiaries and determine to whom property shall pass on final or partial termination of the trust (Prob C §17200(b)(4)); or
- Modify, terminate, or combine trusts (Prob C §17200(b)(13)-(14)).

NOTE: Issues relevant to determining the applicability of no-contest clauses are relevant to trust proceedings. The same rules of construction apply whether the document is a will, a trust, or any other instrument. See discussion of creditor claims and no-contest clauses in §10.34. See also California Trust and Probate Litigation, chap 5, §20.1 (Cal CEB 1999).

For full discussion of actions to determine the validity of a trust and sample forms, see Trust & Prob Litig, chaps 6, 20.

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§15.26 3. Instructing the Trustee

A trustee who wants court guidance on an issue concerning administration of the trust (including how to protect against potential liability), or a beneficiary who wants an issue resolved a particular way, may petition the probate court concerning the trustee's actions and ask the court to instruct the trustee. Prob C §17200(b)(6). This approach is typically used in disputes regarding the handling of the trust when the beneficiary wants the trustee to take a course of action with which the trustee disagrees. In any case, the trustee should propose a course of action; it is not enough in a §17200 petition to simply set out possible courses of action and request that the court determine which course of action the trustee should take. See §15.28.

The Trust Law does not specify a definitive list of subjects for Prob C §17200(b)(6) petitions for instructions. Some matters can clearly be raised; for example, it is proper to ask the court to intervene when cotrustees have equal powers and cannot come to a unanimous decision, as required under Prob C §15620. Similarly, if one cotrustee has sole power over a certain trust activity and a cotrustee without power believes that a proposed act would constitute a breach of the trust, the cotrustee without the power may petition the court for instructions.

A petition for instructions is helpful when there is a question about an allocation of charges between income and principal that is equitable for all classes of beneficiaries. Also, when the trust instrument contains no provisions establishing reserves for remainder interests, the trustee can seek instructions on how best to create and maintain reserves to balance depreciation or depletion of certain assets. A trustee faced with a potential conflict of interest can obtain protection by petitioning the court for instructions.

When the trustee or trustee's attorney anticipates that a beneficiary's objection to the trustee's past or proposed actions could lead to a surcharge petition in the probate court or to a civil suit, the trustee is advised to seek court instructions or approval of an action under Prob C §17200(b)(6).

PRACTICE TIP: As an alternative to a petition for instructions, the trustee may send a notice of proposed action under the provisions of Prob C §§16500-16504 and wait 45 days for objections and then act if no objections are received. The notice procedure is optional (Prob C §16504) and is available for actions governed by Prob C §§16200-16249 (regarding powers of trustees) or Prob C §§16320-16375 (the Uniform Principal and Income Act (UPAIA)) (Prob C §16500), some of which actions are among those listed in Prob C §17200. See §§2.59A-2.59B.

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§15.27 4. Determining Questions of Construction of Trust Instrument

Trustees commonly petition for instructions to clarify ambiguous trust provisions, such as investment clauses or beneficiary designations. See Prob C §17200(b)(1). See also, *e.g., Estate of Keet* (1940) 15 C2d 328, 333, 100 P2d 1045; *Estate of Brown* (1962) 199 CA2d 274, 18 CR 435.

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§15.28 5. Passing on the Exercise of Discretionary Powers

The Trust Law is not intended to change the general rule that the court will not substitute its judgment for that of the trustee. Once the trustee has exercised discretion, however, the court is expressly empowered to review the exercise under Prob C §17200(b)(5). For example, in *Estate of Marre* (1941) 18 C2d 184, 114 P2d 586, the court found it proper for the probate court to order payments for a beneficiary's support after the beneficiary petitioned for instructions. The court reversed the trial court's order setting a specific amount for support on the ground that this was a matter solely within the trustee's discretion.

When the trustee is unsure about the propriety of making or denying a discretionary distribution, it is appropriate to petition the court for instructions. The petition should state all pertinent facts and may present all points of view through declarations of the trustee or beneficiaries. This protects the resulting court order from collateral attack for fraud or malfeasance. In contrast to most petitions for instructions, the trustee should not state a preferred course of action in a proposed order because this would likely violate the impartiality of the trustee. Instead, the trustee should present both arguments as equally valid and let the court decide. The trustee has the burden of proving that its exercise of the power will be reasonable. *Estate of Nicholas* (1986) 177 CA3d 1071, 223 CR 410.

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§15.29 6. Compelling an Account

Disputes with trustees can arise over the demand by beneficiaries that the trustee prepare and submit a report or account, either directly to them or to the court. A beneficiary may compel the trustee to report or account if a report or account has not been rendered during the previous 6 months. The beneficiary must first show that he or she has requested a report or account from the trustee and that the trustee has failed to submit the report or account within 60 days. Prob C §17200(b)(7). The statute requires such a report or account to be presented directly to the beneficiaries. However, if the beneficiaries also request the court to settle the accounts under Prob C §17200(b)(5), it would be logical for the court to order the trustee to account directly to it.

In addition to the options provided by Prob C §17200, under Prob C §16064(a) beneficiaries have standing to petition the court to compel the trustee to report and account on a showing of reasonable likelihood that a material breach of the trust has occurred, even if the trust instrument waives accounts. Section 16064(a) does not expressly waive the Prob C §17200(b)(7) requirements of a written request, a 60-day wait, and lack of an account within the preceding 6 months; logic suggests, however, that these requirements should not apply when a breach of trust may have occurred. What need is there for a businesslike period to prepare an account or for avoidance of repetitious accounts when it is shown that a material breach is reasonably likely to have occurred? Furthermore, the petition in such a situation could be founded alternatively on Prob C §17200(b)(12) (compelling redress of breach of trust), which is not preconditioned on a written request, a 60-day wait, or the absence of a recent prior account.

Generally, the fiduciary's duty to account is a continuing one, and therefore the right to compel an account is not barred by a statute of limitations. *Estate of Schneider* (1979) 95 CA3d 55, 60, 156 CR 838.

For full discussion, see chap 7; California Trust and Probate Litigation, chap 13 (Cal CEB 1999).

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§15.30 7. Objecting to an Account

The Trust Law does not expressly provide for a beneficiary's right to object to a petition for settlement of an account. However, the income and remainder beneficiaries, including contingent beneficiaries, have standing to object to an accounting, because they have the right to compel an accounting (Prob C §17200(b)(7)) or to compel a redress of a breach of trust (Prob C §17200(b)(12)). The beneficiary can object on any grounds that could otherwise be raised in a suit for breach of trust. See §15.44A.

In a revocable trust, except to the extent that the trust instrument otherwise provides or if the joint action of the settlor and all beneficiaries is required, the settlor and the person holding the power to revoke (as long as they are competent) have the power to object during their lifetime. Prob C §15800. For minor beneficiaries, a guardian ad litem may be required (see §15.16); however, the court may permit a parent or guardian to raise objections on behalf of the minor without the necessity of a formal appointment of a guardian ad litem.

NOTE: If the parent of a minor is also a beneficiary, the parent's interests may conflict with those of the minor, and an independent guardian ad litem may be needed. See §15.17.

When a trustee has filed an account and seeks court approval, an objection can be made in writing at or before the hearing, or orally at the hearing. Prob C §1043(a)-(b). Counsel should consult local court rules to see whether the county imposes any restrictions. The attorney representing a beneficiary who plans to object should always move promptly to file the objections and to have the hearing to settle the account continued in order to have time to properly defend the beneficiary's interests. The attorney for the trustee, on the other hand, has a responsibility to see that the hearing to settle the account is not delayed for spurious reasons, or simply because of vague, unsubstantiated threats from a beneficiary. Keep in mind that in some counties, if there are objections, the case is sent to mediation.

For full discussion, see California Trust and Probate Litigation, chap 13 (Cal CEB 1999).

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8. Redressing Breach of Fiduciary Duty

§15.31 a. Grounds for Claim of Breach of Trust

A petition under Prob C §17200(b)(12) may be brought to compel redress of a breach of the trust. A breach of trust is a violation by the trustee of any duty that the trustee owes a beneficiary. Prob C §16400. See also *Estate of Gump* (1991) 1 CA4th 582, 595, 2 CR2d 269. Ordinarily, a trustee must be personally at fault to be liable for breach of trust. Restatement (Second) of Trusts §201, Comment a (1959). This fault requirement is satisfied when the trustee commits a breach of trust

- In bad faith;
- Knowingly but in good faith; or
- Negligently.

Restatement (Second) §201. Negligence is the failure of the trustee to meet the applicable standard of care. *Estate of Gump, supra*. See §15.32.

Even in the absence of negligence, a breach of trust may occur when the trustee mistakenly interprets the trust instrument or trust law as authorizing an act that the court determines is not in fact authorized. Restatement (Second) §201, Comment b. Good faith reliance on the advice of counsel will not exonerate a trustee from acts that exceed the trustee's authority. If in doubt, the trustee can gain a measure of protection by applying to the court for instructions. See Restatement (Second) §201. But see *Estate of Gilmaker* (1964) 226 CA2d 658, 663, 38 CR 270 (trustee must exercise *reasonable diligence* to ascertain nature and extent of obligations).

For full discussion of the duties of a trustee, see chaps 2 and 5. For full discussion of breach of trust, see California Trust and Probate Litigation, chap 21 (Cal CEB 1999).

The trustee has a duty to take reasonable steps to enforce claims that are part of trust property or defend actions that may result in loss to the trust. Prob C §§16010-16011.

The duty of the trustee to protect and enhance the trust includes the obligation to litigate claims against third parties. Prob C §16010; Restatement (Third) of Trusts §76 (2007); Restatement (Second) of Trusts §177 (1959). A trustee who breaches the duty to litigate a claim or collect a debt is subject to an action for surcharge. *Purdy v Johnson* (1917) 174 C 521, 163 P 893.

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§15.32 b. Standard of Care

The prudent trustee rule imposes a standard of care with respect to noninvestment duties that requires the trustee to use the reasonable skill, care, and caution that a prudent person acting in a similar capacity would use to accomplish the purposes of the trust. Prob C §16040(a). The rule requires the trustee to perform his or her duties in good faith and with reasonable prudence, discretion, and intelligence. *Estate of Cousins* (1896) 111 C 441, 44 P 182; *Estate of Bissinger* (1963) 212 CA2d 831, 840, 28 CR 217. It does not make a trustee, however, the insurer of all trust losses, impose liability for every mistake of judgment, or require the trustee to exercise extraordinary care. See, *e.g., Pillsbury v Karmgard* (1994) 22 CA4th 743, 762, 27 CR2d 491 (trustee reasonably decided not to pursue action for malicious prosecution).

Although the prudent trustee rule applies to many of the trustee's functions, a somewhat different standard applies to investment and management functions covered by the Uniform Prudent Investor Act; see Prob C §16040(c). See chaps 2 and 5. Different rules also guide the court's review of a trustee's discretionary functions.

For further discussion of standard of care, see chap 2; California Trust and Probate Litigation, chap 21 (Cal CEB 1999).

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§15.33 c. Elements of Cause of Action Against Trustee

The trustee is liable for losses to the trust only when they result from a breach of trust. Prob C §16440(a). Restatement (Second) of Trusts §204 (1959). The trustee is not a guarantor or insurer of the trust's principal or interest. There must be some causal link between the trustee's breach and the injury sustained by the trust or beneficiary. *Vale v Union Bank* (1979) 88 CA3d 330, 338, 151 CR 784 (loss to the trust was direct and proximate result of trustee's breach).

When there is a single breach of trust, resulting in losses as well as gains, the trustee may be permitted to offset one against the other in any surcharge action or action for damages. See Restatement (Second) of Trusts §213 (1959). When the breaches of trust are separate and distinct, however, the court will not permit the trustee to offset gains against losses, presumably because it might lead a trustee to attempt to recoup losses through further improper actions, *e.g.,* by securities speculation. 4 Scott & Ascher on Trusts §24.18 (5th ed 2007). Furthermore, Prob C §16440 requires a trustee to make good whatever is lost through a breach.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.34 d. Trustee's Affirmative Defenses

§15.34 d. Trustee's Affirmative Defenses

The trustee may defend against a claim of breach of fiduciary duty by asserting a number of affirmative defenses, including:

- Consent or affirmation by beneficiaries;
- Statute of limitations;
- Res judicata; and
- Laches.

See §§15.35-15.38. For full discussion, see California Trust and Probate Litigation, chap 21 (Cal CEB 1999).

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§15.35 (1) Consent or Affirmation by Beneficiaries

The adult, competent beneficiaries of a trust can consent to a breach of trust, or can affirm a transaction that was a breach, after the fact. Prob C §§16463, 16465. The trustee has the burden of proving that the underlying transaction was fair to all participating parties. See Prob C §§16463(c), 16465(b)(4); *McDonald v Hewlett* (1951) 102 CA2d 680, 686, 228 P2d 83. It is risky for a trustee to rely on the beneficiaries' consent to a breach or their later affirmation of a transaction, and the trustee's counsel should not advise doing so. Other methods are available that provide better protection for the trustee. If the trustee wishes approval of some action, he or she should ask for instructions and guidance from the court or send a notice of proposed action if the action is one that can be the subject of a notice of proposed action under Prob C §§16500-16504 (see §§2.59A-2.59B) rather than take the risk that a later review of the actions will show that the beneficiary was not fully informed, that a request for the beneficiary's consent was improper, or that the terms of the transaction were unfair to the trust or the beneficiary.

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§15.36 (2) Statute of Limitations

The general statute of limitations for claims for breach of trust is Prob C §16460, which prescribes a 3-year period. However, that 3-year period does not begin to run until the beneficiary discovers or reasonably should have discovered the breach. Prob C §16460(a)(2); *Di Grazia v Anderlini* (1994) 22 CA4th 1337, 28 CR2d 37; *Oeth v Mason* (1967) 247 CA2d 805, 811, 56 CR 69. Note that the settlor (or the person who holds the power to revoke), not the beneficiary, of a revocable trust is the one who receives the trustee's account under Prob C §16062 and is thus the only one to whom disclosure is made. Prob C §§16064, 15800.

Note also that a trust instrument may contain specific language relieving the trustee of liability for a breach of trust if the beneficiary fails to object to the trustee's account or report within a specified period of time, which cannot be less than 180 days. Prob C §16461. See §7.65 for further discussion of Prob C §16461. Failure to object within the 180 days bars later objections, but an objection within the 180 days allows the objector 3 years from the date the account or report was received to initiate litigation.

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§15.37 (3) Res Judicata

Over the years, trustees' attorneys generally have assumed that a basic tenet of trust law is that, once a fiduciary's accounting is approved and settled, matters covered by that accounting are res judicata and thus free from later attack. *Estate of Bissinger* (1964) 60 C2d 756, 761, 36 CR 450. However, the trustee's counsel who relies on res judicata to protect the client may experience an unwelcome surprise when a court determines that specific actions were not so covered. See, *e.g., Estate of Schneider* (1979) 95 CA3d 55, 156 CR 838. The trustee had filed seven annual accountings before the beneficiaries finally objected that not all funds were being accounted for. The trustee claimed the protection of res judicata, and the trial court agreed; on appeal, however, the court found that because the trust accountings had merely reported net revenue received, res judicata did not apply. The court held that settlement of a trust account does not bar income beneficiaries from further complaints except as to items included in the account and actually passed on by the probate court. 95 CA3d at 59. See also *Estate of Anderson* (1983) 149 CA3d 336, 196 CR 782, in which the court found that an executor's misrepresentation and concealment of material facts from the beneficiaries precluded a defense of res judicata to underlying actions that were disclosed in the executor's second account. Although this case dealt with an estate, it stands as a caveat to any fiduciary because, despite the fiduciary's informal advice and communication to the beneficiaries, the court determined that material facts had been concealed.

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§15.38 (4) Laches

Even if a cause of action might otherwise be properly brought under the statute of limitations as a result of the reasonable failure to discover or the presumptions against the trustee discussed above, the action might still be barred by application of the doctrine of laches. Prob C §16460; Comment to Prob C §16460; see also Restatement (Second) of Trusts §219(1) (1959), which provides, "The beneficiary cannot hold the trustee liable for breach of trust if he fails to sue the trustee for the breach of trust for so long a time and under such circumstances that it would be inequitable to permit him to hold the trustee liable." See *Hovey v Bradbury* (1896) 112 C 620, 44 P 1077. See also California Civil Procedure Before Trial §25.47 (4th ed Cal CEB 2004).

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§15.39 e. Aiding or Abetting Breach of Trust

A trust beneficiary may sue third parties who, for their own financial advantage, actively participated with the trustee in a breach of trust, whether by inducing, aiding, or abetting the breach, or by receiving trust property from the trustee in knowing breach of the trust. *Wolf v Mitchell, Silberberg & Knupp* (1999) 76 CA4th 1030, 90 CR2d 792; *City of Atascadero v Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1998) 68 CA4th 445, 80 CR2d 329. A third person assisting a trustee with a transaction need not, however, inquire whether the trustee has the power to conduct the transaction, and is protected as if the trustee is properly exercising such power, so long as the person acts in good faith for valuable consideration and without actual knowledge that the trustee is exceeding or improperly exercising his or her powers. Prob C §18100; *Vournas v Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 86 CR2d 490.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.39A C. Grounds for Prob C §850(a)(3) Petition

§15.39A C. Grounds for Prob C §850(a)(3) Petition

Under Prob C §850(a)(3), a trustee or any interested person may file a petition when:

- The trustee is in possession of, or holds title to, real or personal property, and the property, or some interest, is claimed to belong to another;
- The trustee has a claim to real or personal property, title to or possession of which is held by another; and
- The property of the trust is claimed to be subject to a creditor of the settlor of the trust.

A Prob C §850 petition may also include claims, causes of action, or matters that are normally raised in a civil action to the extent that the matters are related factually to the subject matter of the §850 petition. Prob C §855.

This proceeding may be used to seek a court order that property listed on a trust schedule, title to or possession of which was not formally transferred to the trust, is nevertheless a trust asset. This statute codifies the holding of *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433, in which the court held that a written declaration of trust by the owner of real property that included an attached schedule listing a specific property was sufficient to create a trust in that property, and a transfer of title was unnecessary when a settlor declares himself or herself to be a trustee in his or her own property. See §15.40B for a sample form.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/ D. Petition Procedure/§15.40 1. Procedure for Prob C §17200 Petition

D. Petition Procedure

§15.40 1. Procedure for Prob C §17200 Petition

Petitions under Prob C §17200 follow the procedures stated in Prob C §§17201-17210. The proceeding is commenced with the filing of a verified petition showing that the petition is authorized and stating the grounds of the petition and the names and addresses of each person entitled to notice of the petition. Prob C §§1021, 17201. The clerk sets the matter for hearing. See §15.40C on notice requirements for a Prob C §17200 petition and §15.40D for chart of notice requirements.

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§15.40A 2. Procedure for Prob C §850(a)(3) Petition

Petitions under Prob C §850(a)(3) follow the procedures stated in Prob C §§850-859. The proceeding under Prob C §850 is commenced with the filing of a verified petition stating the facts on which the claim is based and the names and addresses of each person entitled to notice of the petition. Prob C §§1021, 850(b). The clerk sets the matter for hearing. See §15.40E on notice requirements for a Prob C §850(a)(3) petition and §15.40F for chart of notice requirements.

PRACTICE TIP: Counsel should consider all provisional remedies, including a lis pendens if title to real property is at issue, and a writ of attachment if personal property is at issue in the Prob C §850(a)(3) proceeding. Although there are tactical advantages to imposition of a lis pendens (*e.g.,* cutting off the claims of a bona fide purchaser), it effectively ties up title to the property and should be used with caution with respect to possible exposure. In *Campbell v Superior Court* (2005) 132 CA4th 904, 34 CR3d 68, the court held that a complaint seeking imposition of a constructive trust on real property that was allegedly improved with money acquired by undue influence did not establish a "real property claim" for purposes of the lis pendens statute. Accordingly, the lis pendens was properly expunged. See generally CCP §§405-405.61; California Real Property Remedies and Damages, chap 13 (2d ed Cal CEB 2002).

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.40B E. Form: Sample Petition for Order Confirming Trust Assets

§15.40B E. Form: Sample Petition for Order Confirming Trust Assets

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NAME
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Address
City, California ZIP
Telephone
Attorney for Petitioner

SUPERIOR COURT OF CALIFORNIA
COUNTY OF CONTRA COSTA

In re THE SMITH LIVING TRUST	**Case No.: _ _ _ _ _ _**
Under Agreement Dated June 1, 2009	**PETITION FOR ORDER CONFIRMING TRUST ASSETS (PROBATE CODE SECTION 850(a)(3))**
	Hearing Date: _ _[*date*]_ _
	Time: _ _[*time*]_ _
	Dep't: _ _[*number*]_ _
	Judge: _ _[*if known*]_ _

Petitioner, MARY SMITH, alleges that:

1. The Petitioner is the presently acting Trustee of THE SMITH LIVING TRUST UNDER AGREEMENT DATED JUNE 1, 2004. A true and correct copy of THE SMITH LIVING TRUST UNDER AGREEMENT DATED JUNE 1, 2009, is attached as Exhibit "1" and incorporated by this reference (the "Trust").

2. Venue is proper in Contra Costa County. The Petitioner is a resident of Contra Costa County and the principal place of trust administration is in Contra Costa County.

3. JOHN SMITH died on January 1, 2010. Before his death, JOHN SMITH and his spouse, MARY SMITH, were in the process of transferring title of all their assets into the Trust. On or about June 15, 2009, John Smith wrote to Peter Principle, his stockbroker at Merrill Lynch, and indicated that he wished the account title changed from his name into the name of the Trust. A copy of the June 15, 2009, letter to Peter Principle is attached as Exhibit "2" and incorporated by this reference.

4. Petitioner believes that the trust declaration under which she has been acting trustee is valid.

5. At Paragraph 1.03 of the Trust the Settlors, JOHN SMITH and MARY SMITH, declared that the property described in Schedule A, which is attached to the Trust at Page 18, is transferred in trust to be held, administered, and distributed under the terms of the Trust. The Schedule A lists, among other items, the Merrill Lynch brokerage account, No. 12345. In addition to signing the Trust both as Settlors and as initial Cotrustees, JOHN SMITH and MARY SMITH also signed a document entitled "General Transfer and Assignment" on June 1, 2009 ("Assignment"). A true and correct copy of the Assignment is attached as Exhibit "3" and incorporated by reference. Under the Assignment, the Settlors intended to transfer and assign to the Cotrustees all of the Settlors' interest in all tangible and intangible personal property of whatever nature and wherever situated. The Assignment was intended to specifically include stocks, bonds, mutual funds, and limited partnerships as described in Paragraph 2 on Page 1 of the Assignment.

6. Petitioner requests that this Court confirm that the assets listed in Exhibit "3" are assets subject to the

Trust, and under the control of MARY SMITH as Successor Trustee. Petitioner believes that the assets described in Exhibit "3" are subject to her control as Trustee either under Schedule A attached to the Trust as part of the trust declaration or as validly transferred and assigned under the Assignment.

7. Settlor JOHN SMITH was gravely ill and dying from cancer when he implemented his estate plan. On June 1, 2009, the Settlors signed the Assignment and on June 15, 2009, Settlor JOHN SMITH instructed his stockbroker to transfer the account to the Trust. Settlor JOHN SMITH died before he could officially change the title to his Merrill Lynch account. Petitioner states that it was the Settlors' assumption that their interests in the stocks, bonds, mutual funds, and partnership interests were in the trust once they signed the Assignment and Schedule A of the Trust.

8. Settlor JOHN SMITH was a resident of Contra Costa County, California, at the time of his death. A true and correct copy of his death certificate is attached as Exhibit "4" and incorporated by reference. The Successor Trustee, MARY SMITH, is a resident of Contra Costa County.

9. Article Five, Paragraph 5.08 of the Trust, provides that if one of the initial Cotrustees ceases to act as Trustee, then the surviving Cotrustee should act as sole Trustee. On January 5, 2010, the named Cotrustee, MARY SMITH, executed an Acceptance of Trust by Cotrustee, a copy of which is attached as Exhibit "5." The Trust states that no bond is required of any Trustee (Article Five, Paragraph 5.03).

10. The names, addresses, and ages of the beneficiaries of the Trust, as well as their relationship to the Settlors are set forth below:

Mary Smith, Surviving Spouse
123 Main Street
Anytown, CA

John Smith, Jr., Adult Son
1925 Sandy Rose Court
Anytown, CA

Nancy Doe, Adult Daughter
1940 Sandy Rose Court
Anytown, CA

Peter Smith, Adult Son
3421 Santa Maria Avenue
Anytown, CA

WHEREFORE, Petitioner prays for an Order of this Court that:

1. THE SMITH LIVING TRUST UNDER AGREEMENT DATED JUNE 1, 2009, is valid;

2. The assets set forth in Exhibit "3" are assets subject to the management and control of MARY SMITH, as sole Trustee of THE SMITH LIVING TRUST UNDER AGREEMENT DATED JUNE 1, 2009, under the General Transfer and Assignment document or under Schedule A of the Trust Agreement; and

3. Such other orders as the Court deems just and proper.

Dated: _ _[*date*]_ _

_____
MARY SMITH, Trustee of The Smith Living Trust Under Agreement Dated June 1, 2009

[*Verification*]

Comment: Some courts require the assets to be listed in the petition as well as the order. It is best to describe the assets in the body of the order rather than as an attachment. Inclusion in the order itself is helpful in getting brokerage houses, banks, and other institutions to follow the order. See sample order in §15.47A.

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F. Notice Requirements

§15.40C 1. Notice Requirements for Prob C §17200 Petition

Notice for Prob C §17200 proceedings concerning trusts must be mailed, at least 30 days before the time set for hearing on the petition, to all nonpetitioning trustees, all beneficiaries who are entitled to notice, and, if the petition relates to a charitable trust, the Attorney General. Prob C §17203(a). Notice must also be sent to any beneficiaries who have requested special notice. Prob C §17204(a). With regard to petitions under Prob C §17200(b), paragraphs 2, 4, 5, 6, 8, 12, 16, 20, and 21, an "interested person" must be noticed if they have submitted a request for special notice under Prob C §17204(b)(2). Further, at least 30 days before the hearing, notice of the hearing and a copy of the petition must be served in the manner provided by CCP §§413.10-417.40 (service of summons) on any other person whose right, title, or interest would be affected by the petition. Prob C §17203(b). The court may not shorten the time for giving notice under subdivision (b). Prob C §17203(b). In some counties, if a petition is filed to compel an accounting, the court issues an order to show cause (OSC) that must be personally served on the trustee. The OSC should order the trustee to appear and show cause as to why he or she should not be ordered to account.

If all persons entitled to notice (Prob C §§17100, 17203, 17204; see also Prob C §§851, 1200-1210) have waived notice, it is arguable that the petitioner may submit an ex parte application for an order shortening time. Some courts have accepted such applications if the petitioner can show a compelling reason for the order, such as an imminent tax filing deadline, an emergency, irreparable harm, or immediate danger, while others will not make such an order ex parte. If all parties entitled to notice have waived notice *and* have consented to and joined in the petition, including the petitioner, it is also arguable that the petitioner may submit the petition ex parte, which would include the declarations of all interested parties to whom notice must be given that they have read the petition, agree to all that is petitioned for, and waive notice. In either case, the attorney should consult local rules. In large counties with crowded calendars and detailed administrative rules, the court may not accept such petitions or applications.

On notice in trust proceedings generally, see Prob C §§1200-1214, 17100; Cal Rules of Ct 7.50-7.51. See Prob C §15804 on notice to beneficiaries who hold future interests. Notice may also be given to any person interested in the trust without the need for a court order. Prob C §17105. See *Estate of Nicholas* (1986) 177 CA3d 1071, 223 CR 410, for a discussion of a beneficiary's failure to object timely to improper notice.

See also chart of notice requirements in §15.40D.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.40D 2. Chart: Notice Provisions for Prob C §17200 Petition

§15.40D 2. Chart: Notice Provisions for Prob C §17200 Petition

PROBATE CODE §17200 PETITIONS CONCERNING TRUSTS:
PROB C §17203 NOTICE PROVISION

NOTE: Except as otherwise provided, the general notice provisions of Prob C §§1200-1210 also apply. Prob C §17100.

Days	*Documents to Serve*	*Authority*	*Notice Recipients; Requirements*
30	Notice of hearing	Prob C §17203(a)	Mail to: (1) All trustees; (2) All beneficiaries subject to Prob C §§15800-15805 (see chart of trust beneficiaries in §15.21A; see Prob C §1214 entry in chart in §15.21B (if beneficiary represented by counsel, notice to counsel *and* beneficiary)); (3) Attorney General if charitable trust subject to AG jurisdiction.
30	Notice of hearing and copy of petition	Prob C §17203(b)	Service in the same manner as a summons (CCP §§413.10-417.40) on any person other than a trustee or beneficiary whose right, title, or interest would be affected by the petition and who does not receive notice under Prob C §17203(a) and on any person to be cited into court to show cause why orders requested should not be made NOTE: The court may not shorten time.
30	See Prob C §17203(a) or (b), above	Prob C §17203(c)	If person to be noticed has been deceased over 40 days and no personal representative appointed, and deceased person's right, title, or interest has not passed to any other person, notice may instead be given to: (1) Each heir and devisee of the decedent; (2) All persons named as executor; (3) Persons serving as guardian or conservator of decedent at time of death.
30	See Prob C §17203(a) or (b), above	Prob C §§17204; 1250*	If request for special notice by beneficiary (unless revocable trust) or creditor, Prob C §17203(a) or (b) notice as described above.
5 days after service or receipt	Copy of petition	Prob C §17205	If trustee or beneficiary has filed a notice of appearance related to the petition; or if copy of petition requested.

*Probate Code §1250 does not apply to the extent that Prob C §17204 overrides it, but Prob C §17100, which incorporates Prob C

§1250, applies to trusts unless otherwise provided.

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§15.40E 3. Notice Requirements for Prob C §850(a)(3) Petition

Notice of the hearing and a copy of the Prob C §850(a)(3) petition for conveyance or transfer or property must be served, as provided in CCP §§413.10-417.40, at least 30 days before the time set for hearing on the petition, on all nonpetitioning trustees and each person claiming an interest in, or having title to or possession of, the property. Prob C §851(a). Further, at least 30 days before the hearing, notice of the hearing and a copy of the petition must be served in the manner provided by Prob C §17203 if the matter concerns a trust. If the matter concerns a decedent's estate, notice must be given in the manner provided in Prob C §1220 and if the matter concerns a conservatorship or guardianship, notice must be given in the manner provided in Prob C §1460. Notice under Prob C §850(a) requires service of summons, but notice under Prob C §851(b) may be by mail. In both cases, a copy of the petition must accompany the notice.

A literal reading of Prob C §§1220 and 1460 suggests that only a 15-day notice is required. However, the legislative history of Prob C §851 strongly suggests that this is not the case, because the legislature intended to unify the treatment of quiet title actions involving estates of decedents, wards, and conservatees. See, *e.g.*, Senate Judiciary Committee Analysis of SB 669 (Mar. 20, 2001): "The same 30-day notice of hearing to all persons now entitled to notice for each type of estate claim would be required." Former Prob C §2521 (guardianship/conservatorship), former Prob C §9861 (estates), and Prob C §17203 (trusts) all respectively required 30-day notice. Therefore, it appears that the 30-day notice period explicitly stated in Prob C §851(a) would apply to all persons noticed under either Prob C §851(a) or (b), and that the intention of Prob C §851(b) is to state only the manner of service on persons named in that subsection.

It seems that, in context, Prob C §851(a) (requiring service in the manner of service of a summons) refers to such fiduciaries as listed in Prob C §850, *i.e.*, those either possessing or holding title to real or personal property, or those claiming property in the possession or title of another. However, when such person is the petitioner, notice is not required. Prob C §1201.

Subsection (b) of Prob C §851 then seems to refer only to the manner of service (*i.e.*, by mail) of all other persons normally entitled to notice in that type of proceeding, *i.e.*, in a trust proceeding, to all trustees and beneficiaries normally noticed. The legislative history quoted above shows the intention that persons normally entitled to notice in a particular type of a proceeding be given notice in a Prob C §850 proceeding. For example, if a trust beneficiary, who is not a person listed in Prob C §850 but just a beneficiary entitled to notice under Prob C §17203, happens to be a conservatee, then the conservator of the beneficiary would receive mailed notice under Prob C §851(b) and not service under Prob C §851(a).

NOTE: The court may not shorten the time for giving such notice. Prob C §851(c).

Depending on a county's local rules, it may be possible to obtain an ex parte order shortening time or to file an ex parte petition and order and thus avoid the 30-day notice period. Some courts have accepted such applications, while others will not make such an order ex parte. See discussion in §15.40C. See also chart of notice requirements in §15.40F.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.40F 4. Chart: Notice Provisions for Prob C §850(a)(3) Petition

§15.40F 4. Chart: Notice Provisions for Prob C §850(a)(3) Petition

PROBATE CODE §850 PETITION FOR CONVEYANCE OR TRANSFER OF PROPERTY: PROB C §851 NOTICE PROVISION

Days	*Documents to Serve*	*Authority*	*Notice Recipients; Requirements*
30	Notice of hearing and copy of petition	Prob C §851(a)	**Serve summons** as provided in CCP §§413.10-417.40 (or citation) on the following: (1) Personal representative, conservator, guardian, or trustee; (2) Each person claiming an interest in or having title to, or possession of, the property.
30 (see discussion in §15.40E)	Notice of hearing and copy of petition	Prob C §851(b)	In addition to persons under Prob C §851(a) (see above) **mail** notice and copy to: (1) If decedent's estate, per Prob C §1220, to personal representative, persons who file request for special notice, and to any heir or devisee whose interest in the property may be affected; (2) If conservatorship or guardianship, per Prob C §1460, to guardian or conservator, ward or conservatee, spouse or domestic partner of ward or conservatee, requests for special notice); (3) If trust, per Prob C §17203. See §§15.40C-15.40E.
		Prob C §851(c)	NOTE: The court may not shorten time.

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§15.41 G. When Court Must Deny, Abate, or Dismiss Petition

If a person having or claiming title to or an interest in the property that is the subject of the Prob C §851(a)(3) petition objects to the hearing, at or before the hearing, on the grounds that the petition has been filed in a court that is not the proper court under any other provision of law for the trial of a civil action seeking the same relief, and if the objection is sustained, the court must not grant the petition. Prob C §853.

On the request of any party to the civil action, the court must abate a Prob C §850 petition until the conclusion of the civil action, if a civil action is pending with respect to the subject matter of the §850 petition and jurisdiction has been obtained in the court where the civil action is pending before the filing of the §850 petition. Prob C §854. The section expressly does not apply if the court finds that the civil action was filed for the purpose of delay.

The court may not grant a Prob C §850 petition if the court determines that the matter should be determined by a civil action. Prob C §856.5.

The court may dismiss a Prob C §17200 petition when it appears that the "proceeding is not reasonably necessary for the protection of the interests of the trustee or beneficiary." Prob C §17202. The court is given broad and flexible power to do what it considers appropriate. See Prob C §17206. When it is appropriate, the court has power to transfer an action from civil court to probate court under CCP §396.

Probate Code §17209 states that trust administration is intended to be expeditious and free of judicial intervention but subject to the jurisdiction of the court.

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§15.42 H. Discovery Rules

Discovery rules applicable to civil litigation generally apply in trust litigation. Prob C §1000. Thus, the attorney for the beneficiaries is entitled to serve interrogatories and take depositions; and the trustee, through his or her counsel, is entitled to defend and exercise the same prerogatives. *Coberly v Superior Court* (1965) 231 CA2d 685, 42 CR 64 (full range of discovery available to beneficiary seeking to challenge account of trustee on grounds trustee had neglected its duty).

Attorneys representing trustees too often forget that the rules of practice applicable to civil actions also apply to proceedings under the Probate Code. Prob C §1000. See, *e.g., Estate of Morrison* (1932) 125 CA 504, 14 P2d 102 (dismissal for delay in prosecuting under former CCP §583; right to dismissal under CCP §581), and *Estate of Bemmerly* (1930) 110 CA 550, 294 P 33 (right to directed verdict). In addition, practitioners should consider such tactics as demurrer, motions to strike, and motions for summary judgment. See generally California Civil Procedure Before Trial, chaps 23-24, 27, 36 (4th ed Cal CEB 2004).

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§15.43 I. Exculpatory Clauses for Benefit of Trustee

Trust instruments often contain exculpatory clauses that attempt to hold trustees harmless from the consequences of their actions taken on behalf of the trust, often from negligent acts performed in good faith. Such provisions are valid, except as to breaches of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the interests of the beneficiary; also, they do not apply to any profit the trustee derived from the breach. Prob C §16461(a)-(b). Specific requirements apply to provisions relieving the trustee from liability for a breach of trust if the beneficiary fails to object to an account or report within a specified time. Prob C §16461(c)-(j). See §7.65. Exculpatory clauses are always strictly construed. *Estate of Collins* (1977) 72 CA3d 663, 673, 139 CR 644. In *Betts v Bank of America* (2007) 156 CA4th 222, 67 CR3d 152, the court held that a proposed petition for an order surcharging a corporate trustee for allegedly distributing funds to a bank account not controlled by the settlor would not violate the trust's no-contest clause as an attempt to nullify the trust's exculpation clause. The clause expressly provided that the trustee would be liable for "willful misconduct or breach of good faith" and the petition alleged that the payments constituted willful misconduct and were made in bad faith.

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§15.44 J. Remedies Available

The superior court having jurisdiction over trusts under the Trust Law has the full powers of the superior court in trust matters. Prob C §17001. With regard to any petition brought under Prob C §17200, the court has the power to make any orders and take any other action necessary or proper to dispose of the matters presented, including appointment of a temporary trustee to administer the trust in whole or in part. Prob C §17206. On suspension of trustee powers, see §15.44A. On remedies for breach of trust, see §15.44B.

With regard to a Prob C §850 petition, if the court is satisfied that a conveyance, transfer, or other order should be made, the court must make an order authorizing and directing the trustee, or the person having title to or possession of the property, to execute a conveyance or transfer to the person entitled to the property, or grant other appropriate relief. Prob C §856.

If a court finds that a person has in bad faith wrongfully taken, concealed, or disposed of property belonging to a trust, the person shall be liable for twice the value of the property recovered in an action brought under Prob C §§850-859. This remedy is in addition to any other remedies in law available to a trustee. Prob C §859.

In *Estate of Young* (2008) 160 CA4th 62, 72 CR3d 520, the court held that the trial court abused its discretion when it denied a personal representative's motion to reopen a Prob C §850 trial to present evidence of the value of real estate that the court had determined belonged to the estate. Because there was no valuation evidence in the record, the denial prevented the estate from recovering double damages under Prob C §859. The estate was entitled to damages because the trial court determined that the decedent's transfers of property to "land trusts" were the result of fraud and undue influence.

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§15.44A 1. Suspension of Trustee Powers

In *Schwartz v Labow* (2008) 164 CA4th 417, 78 CR3d 838, the court held that a probate department judge had jurisdiction to suspend a trustee's powers and appoint a temporary trustee even though no formal petition for removal had been filed by an interested party under Prob C §17200. The court stated that the court had power to suspend a trustee on its own motion under Prob C §15642; the trustee himself had initiated proceedings to pass upon his acts by filing an account and petition for its settlement, and objections filed to the petition had sought suspension. See §7.56B. Further, the court held that the trustee had no right to refuse to turn over original trust documents to the court-appointed successor trustee.

The trustee had encumbered and then sold the deceased settlors' residence to pay the expenses of litigation in a quiet title action brought by the settlors' daughter, which resulted in an elder abuse judgment against the daughter in favor of the trustee and the settlors' conservator that the conservator concluded probably could not be collected. In a related decision, the court of appeal vacated the elder abuse judgment and the trial court's award of $517,869 in trustee fees and $1 million in attorney fees to the trustee. *Sanders v Lawson* (2008) 164 CA4th 434, 78 CR3d 851. The court held that the trial court abused its discretion when it denied the daughter's motion to reopen discovery. The court noted that the trial court was not authorized to award trustee fees in addition to conservator fees under Welf & I C §15657.1.

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§15.44B 2. Remedies for Breach of Trust

In addition to the remedies described above, if a trustee commits a breach of trust, or threatens to commit a breach of trust, a beneficiary or cotrustee of the trust may seek an order under Prob C §16420(a):

- For injunctive relief, including an order to compel the trustee to perform the trustee's duties or to enjoin the trustee from committing a breach of trust;
- To compel the trustee to redress a breach of trust by payment of money or otherwise (see §15.45);
- To appoint a receiver or temporary trustee to take possession of the trust property and administer the trust;
- To remove the trustee;
- To set aside acts of the trustee (within certain limitations);
- To reduce or deny compensation of the trustee;
- To impose an equitable lien or a constructive trust on trust property (within certain limitations); and
- To trace trust property that has been wrongfully disposed of and recover the property or its proceeds (within certain limitations).

These remedies do not preclude any other appropriate remedy provided by statute or the common law. Prob C §16420(b). A beneficiary's remedies against the trustee are exclusively in equity and there is no right to a jury trial in trust matters in probate court. Prob C §§16421, 17006.

Under CC §3422(4), a final injunction may be granted to prevent the breach of an obligation existing in favor of the applicant when the obligation arises from a trust.

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.45 K. Measure of Trustee Liability for Breach of Trust

§15.45 K. Measure of Trustee Liability for Breach of Trust

If the trustee commits a breach of trust, the trustee is chargeable with any of the following that is appropriate under the circumstances (Prob C §16440(a)):

- Any loss or depreciation in value of the trust estate resulting from the breach of trust, with interest;
- Any profit made by the trustee through the breach of trust, with interest (see *Nickel v Bank of America* (9th Cir 2002) 290 F3d 1134); and
- Any profit that would have accrued to the trust estate if the loss of profit is the result of the breach of trust.

If the trustee is liable for interest under Prob C §16440(a), the trustee is liable for the greater of the following amounts (Prob C §16441(a)):

- The amount of interest that accrues at the legal rate on judgments in effect during the period when the interest accrued; or
- The amount of interest actually received.

If the trustee has acted reasonably and in good faith under the circumstances as known to the trustee, the court in its discretion may excuse the trustee in whole or in part from liability under Prob C §§16440(a) and 16441(a) if it would be equitable to do so. Prob C §§16440(b), 16441(b).

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§15.46 L. Costs and Fees

The costs of a proper petition by the trustee are chargeable to the trust. Prob C §15684. If the petition is clearly unwarranted, the trustee could be personally liable for the cost of the proceeding (see Prob C §16420), but this is extremely rare. See 3 Scott & Ascher on Trusts §18.1.2.4 (5th ed 2007). See discussion in chap 9.

Some attorneys always request court approval of attorney fees in a Prob C §850 petition in order to use them as a negotiation point at a mediation.

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§15.47 M. When Order May Be Appealed

If the underlying action by beneficiaries is in the probate court, Prob C §§1300 and 1304 control which orders are appealable. Orders that are appealable under Prob C §1300 include those:

- Directing, authorizing, approving, or confirming the sale, lease, encumbrance, grant of an option, purchase, conveyance, or exchange of property;
- Settling an account of a fiduciary;
- Authorizing, instructing, or directing a fiduciary, or approving or confirming the acts of a fiduciary;
- Directing or allowing payment of a debt, claim, or cost;
- Fixing, authorizing, allowing, or directing payment of compensation, or expenses of an attorney or fiduciary; or
- Surcharging, removing, or discharging a fiduciary.

Under Prob C §1304, any final order under Chapter 3 of Part 5 of Division 9 of the Probate Code (Prob C §§17200-17211) is appealable, except an order compelling the trustee to submit an account or report acts as trustee, or accepting the trustee's resignation.

There is no difference in appealing an order against or by a trustee as opposed to any other appealable motion or judgment. On appeals generally, see California Civil Appellate Practice (3d ed Cal CEB 1996).

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Source: Estate Planning/California Trust Administration/15 Court Proceedings/§15.47A N. Form: Sample Order Confirming Trust Assets

§15.47A N. Form: Sample Order Confirming Trust Assets

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF CONTRA COSTA

In re THE SMITH LIVING TRUST	**Case No. _ _ _ _ _ _**
Under Agreement Dated June 1, 2009	**ORDER CONFIRMING TRUST ASSETS (PROBATE CODE §850(a)(3))**

The petition of _ _[*name of trustee*]_ _, as the presently acting Trustee of the above-titled Trust, for an order of this Court confirming Trust assets under California Probate Code §850(a)(3) was heard by this Court on _ _[*date*]_ _, in Department _ _[*number*]_ _, the Honorable _ _[*name*]_ _ Judge presiding. _ _[*Name of attorney*]_ _ appeared on behalf of Petitioner.

The Court finds that all notices have been given as required by law and that the allegations contained in the Petition are true;

That Petitioner is the named sole Trustee of the above-titled Trust as the surviving Cotrustee following the death of JOHN SMITH;

That the property described in Schedule A attached to the Trust signed by Petitioner and JOHN SMITH as Settlors and as initial Cotrustees, including the Merrill Lynch brokerage account, No. 12345 of JOHN SMITH, is transferred in trust under the terms of the Trust;

That under the General Transfer and Assignment signed by Petitioner and JOHN SMITH, the Settlors intended to transfer and assign to Cotrustees all of their interest in the assets listed in Exhibit "3" attached to the petition, specifically including stocks, bonds, and mutual funds;

That good cause appearing, grants the petition as follows:

IT IS ORDERED that:

1. THE SMITH LIVING TRUST UNDER AGREEMENT DATED JUNE 1, 2009, is valid;

2. The following assets are trust assets subject to the management and control of MARY SMITH, as Successor Trustee of THE SMITH LIVING TRUST UNDER AGREEMENT DATED JUNE 1, 2009:

[*Insert list of assets*]

Date: _ _ _ _ _ _ **__[*Signature*]__**
Judge of the Superior Court

Comment: See sample petition in §15.40B.

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VI. LITIGATION INVOLVING TRUSTEE AND THIRD PARTIES

A. Pursuit of Claims

§15.48 1. Duty to Pursue Claims

The trustee has the power to prosecute or defend actions, claims, or proceedings in order to protect trust property and the trustee in the performance of his or her duties. Prob C §16249(a). A trustee may bring the same kinds of actions against third persons as the trustee could maintain if he or she held the trust property free of trust. Restatement (Second) of Trusts §280 (1959). The trustee also has the power to pay, contest, settle, or release a claim by or against the trust. Prob C §16242.

The trustee has a duty to take reasonable steps to enforce claims that are part of trust property or defend actions that may result in loss to the trust. Prob C §§16010-16011. The trustee is required to act "with reasonable care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument." Prob C §16040(a). Depending on the circumstances of the case, it might be reasonable to settle an action or suffer a default rather than prosecute or defend an action.

The trustee's duty to protect and enhance the trust includes the obligation to litigate claims against third parties. Prob C §16010; Restatement (Third) of Trusts §76 (2007); Restatement (Second) of Trusts §177 (1959). A trustee who breaches the duty to litigate a claim or collect a debt is subject to an action for surcharge. *Purdy v Johnson* (1917) 174 C 521, 163 P 893. A trustee should pursue an action on a claim or put pressure on a debtor to collect a debt if a prudent person would do so in like circumstances. *Estate of Gilliland* (1977) 73 CA3d 515, 140 CR 795. See also *Haskett v The Villas at Desert Falls* (2001) 90 CA4th 864, 108 CR2d 888 (successor trustee not personally liable for attorney fees and costs awarded to defendants in law suit brought in representative capacity by prior trustee when there was no proof that successor trustee was personally at fault).

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§15.49 2. Limitations on Duty to Pursue Claims

If it reasonably appears that a claim or debt is uncollectible, the trustee has no duty to file an action to collect it. Likewise, there is no duty to pursue a claim or debt if an action to enforce it would probably be unsuccessful. Restatement (Third) of Trusts §76, Comment d (2007); Restatement (Second) of Trusts §177, Comments a, c (1959). The trustee may use a notice of proposed action under Prob C §§16500-16504 to advise beneficiaries of a decision not to pursue a claim or debt. This will protect the trustee if no beneficiary objects. Prob C §16503(b).

If the trustee pursues litigation and is unsuccessful, the trustee has a duty to appeal the decision if it would be unreasonable under the circumstances not to appeal. *Gray v Union Trust Co.* (1915) 171 C 637, 639, 154 P 306; *Estate of Harvey* (1958) 164 CA2d 330, 330 P2d 478; Restatement (Second) §177, Comment d.

In all events, however, the trustee's duty to pursue litigation on a claim or debt owed to the trust is subject to any contrary provisions in the trust instrument. Prob C §16000. For example, the trust may provide that a particular debt to the trust is to be forgiven on the occurrence of a certain event, as in the case of a loan that is to be forgiven on the death of the trustor.

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§15.50 B. Tort Litigation

A trust's assets are liable for torts committed personally by the trustee or by employees of the trust in the course of administration of the trust estate. See *Johnston v Long* (1947) 30 C2d 54, 59, 181 P2d 645, 648; Restatement (Second) of Trusts §264, Comment b (1959). A trust may also be subjected to liability if the trustee holds title to property on which an injury occurs to third parties as a result of negligence. *Bianchi v Western Title Ins. & Guar. Co.* (1970) 14 CA3d 235, 96 CR 750. The trustee may be personally liable for obligations arising from ownership or control of trust property only if the trustee is personally at fault. Prob C §18001. In *Bianchi*, the title company held title to the property as a trustee for certain designated beneficiaries. But see *Richman v Green* (1956) 143 CA2d 470, 299 P2d 890, in which the trustee who held mere title was not liable for negligence in maintaining the building when the beneficiary controlled the "operation and maintenance of the trust property." 143 CA2d at 473.

PRACTICE TIP: The attorney for the trustee should advise the trustee to obtain appropriate insurance coverage for the trust property and to review the insurance coverage at least annually.

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§15.51 C. Contract Actions

The trustee may be personally liable for contracts on behalf of the trust if the trustee fails to reveal the trustee's representative capacity or identify the trust in the contract. Prob C §18000(a). On contracts entered into before July 1, 1987, the trustee is personally liable unless the contract stipulated that the trustee was not liable. See Prob C §18000(b). The trustee's attorney should review any contract entered into by a trustee to determine whether the trustee has absolved himself or herself from personal liability in an agreement and has properly identified his or her representative capacity; if necessary, the attorney should seek an amendment to the contract. See *Zimmer Constr. Co. v White* (1935) 8 CA2d 672, 47 P2d 1087; 4 Scott & Ascher on Trusts §26.2 (5th ed 2007). If such language was not contained in the contract, the creditor could look to the trustee's personal assets for payment. *Goldwater v Oltman* (1930) 210 C 408, 426, 292 P 624; *Curtis v Title Guar. & Trust* (1935) 3 CA2d 612, 623, 40 P2d 562. These rules still apply to pre-July 1, 1987, contracts.

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16

Modification, Revocation, and Termination of Trust

Sandra Price

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I. MODIFICATION OF TRUST

A. How and Why Trusts Are Modified

§16.1 1. Reasons for Modification

A trustee may find that the terms of a trust are outdated, too restrictive, or not in the best interests of the beneficiaries. For example, a trust might restrict trust investments to government bonds at a time when prudent investment strategy demands that a portion of the portfolio be invested in equities; or a trust may prohibit the trustee from selling any of the original trust assets, some of which may no longer be prudent investments for the trust. The provisions regarding the succession of the trusteeship may no longer be appropriate in light of current ages and experiences of nominated individual successor trustees or industry practices of corporate trustees. The trustee or beneficiaries may also discover that under present conditions the dispositive provisions no longer carry out the settlor's intent or are impossible to fulfill. Prob C §15409(a); *Crocker-Citizens Nat'l Bank v Younger* (1971) 4 C3d 202, 93 CR 214; Restatement (Third) of Trusts §66 (2003).

There may be tax-motivated reasons for wishing to change the terms of a trust, such as:

- The trustee determines it would be beneficial to divide one trust into two trusts to separate property that is exempt from the generation-skipping transfer tax from property that is not exempt.
- The applicable requirements for a statutorily created tax-oriented trust (*e.g.,* a grantor retained annuity trust (GRAT), a qualified personal residence trust (QPRT), a charitable remainder trust (CRT)) were not met by the trust document or have changed and the settlor, beneficiaries, and trustee wish the trust to continue to qualify for the favorable tax treatment.
- The trustee wishes to convert an income trust (*e.g.*, a QTIP marital trust) into a unitrust under the conversion procedures in Prob C §§16336.4-16336.6. See §8.3F.

Bond may be the subject of a petition to modify the terms of the trust. Bond is not required by law unless the trust instrument requires one, or the court finds one to be necessary, or an individual not named as trustee is appointed by the court. Prob C §15602(a). Even if a bond is required by the trust instrument, the court can excuse the requirement of a bond, reduce or increase the amount of a bond, release a surety, or permit the substitution of another bond with the same or different sureties. Prob C §15602(b). The court may also excuse the requirement of a bond for a person not named as trustee in the trust instrument if there are "compelling circumstances." A request by all adult beneficiaries to waive bond for such an individual is deemed to constitute a compelling circumstance. Prob C §15602(b). See §4.44 on bond in general.

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§16.2 2. How Modification Procedures Differ for Revocable and Irrevocable Trusts

If it appears necessary to modify the trust's terms to accomplish the settlor's intent, the trustee's attorney should first determine whether the trust is revocable or irrevocable. If the trust is revocable by the settlor, the settlor can modify the trust. See §§16.5-16.9 for discussion. If the trust is irrevocable, a trustee or beneficiary may petition the court to modify the trust. Alternatively, the settlor and beneficiaries can consent to a trust's modification, as they can to a termination. Prob C §§15403-15404. *City of Coronado v San Diego Unified Port Dist.* (1964) 227 CA2d 455, 38 CR 834. See §§16.10-16.18 for discussion.

Many practitioners speak of "amendment" rather than "modification" of trusts. But the California Probate Code uses the latter term and this book will conform with that usage.

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§16.3 3. Cautionary Notes Regarding Modification of Irrevocable Trusts

Preliminarily, the attorney for the trustee should advise the beneficiaries that he or she represents the trustee and cannot provide legal advice to the beneficiaries, and that the beneficiaries have the right to obtain independent counsel regarding any proposed modifications.

The attorney for the trustee or beneficiary should initially consider whether a no-contest clause in a trust might be triggered by seeking to modify an irrevocable trust. If the possible outcome is unclear, it would be prudent to file a petition under Prob C §21320 to determine whether the proposed petition for modification constitutes a contest within the terms of the particular trust's no-contest clause. In a Prob C §21320 proceeding in *McKenzie v Vanderpoel* (2007) 151 CA4th 1442, 61 CR3d 129, the court held that a trust income beneficiary's proposed filing of a petition to compel the trustee to exercise the Prob C §16336 power to adjust between principal and income to provide an annual income equal to a minimum 4 percent of the value of trust assets would violate the trust's no-contest clause. The proposed petition would have had the same effect as conversion of the trust into a unitrust under Prob C §§16336.4-16336.6. See §8.3F.

NOTE: In 2008, California adopted new comprehensive no-contest provisions in Prob C §§21310-21315. The new statute limits the enforceability of no-contest clauses and will no longer permit "safe harbor" petitions to determine whether proposed actions are contests as currently provided in Prob C §21320. The statutory scheme will become operative January 1, 2010, and will be applicable to instruments whenever executed that became irrevocable on or after January 1, 2001. However, "safe harbor" petitions will remain available for instruments that became irrevocable before January 1, 2001.

A second consideration, for a tax-motivated change to the terms of a trust, is whether the change will be given effect by the Internal Revenue Service (IRS). Modifications may be accomplished under California law but nevertheless not be recognized for federal tax purposes. The IRS honors some modifications because they are authorized by the Internal Revenue Code or the regulations thereunder (*e.g.,* modifying the terms of a trust to qualify it as a "qualified domestic trust" (QDOT) under Treas Reg §20.2056A-4). See discussion in §§16.20A-16.20B. See also IRS Letter Ruling 200649023 (trust modified to vest distribution powers in special trustee for separate fund to be created for property passing to private foundation as a result of disclaimer of power of appointment by disclaimant who was trustee of foundation). On the other hand, the IRS takes the position, upheld by reviewing courts, that it is not required to honor all trust modifications, even when the modification is authorized under California law and is made under an order of the probate court. See *Commissioner v Estate of Bosch* (1967) 387 US 456, 18 L Ed 2d 886, 87 S Ct 1776; *Estate of Rapp v Commissioner* (9th Cir 1998) 140 F3d 1211.

In *Estate of Rapp,* the probate court modified a QTIP trust based on Prob C §§15403 (consent of all beneficiaries) and 15409(a) (modification allowable based on changed circumstances). The court held that the IRS could ignore the probate court's decision and disallow the claimed marital deduction, determining that the original trust did not qualify for the marital deduction and that the court's construction and order modifying the trust was not binding on the IRS. The U.S. Supreme Court decision in *Estate of Bosch* sharply limits the amount of deference that must be given to state court decisions. Although dictum in the opinion suggests that a decision of the "highest court of the State" on a question of state law must be respected (387 US at 465, 18 L Ed 2d at 894), this dictum may not apply to decisions that are not the product of adversarial proceedings and thoughtful deliberation by the court. In *ESB Fin., Trustee of Virginia Biggs Revocable Trust v U.S.* (D Kan, Sept. 23, 2008, No. 07-1059-JTM), the district court held that no charitable deduction was allowed for a reformed charitable remainder trust as a matter of federal law because the petition seeking reformation was not filed by the IRC §2055(e)(3) deadline and because the state court decree did not reform the trust retroactively to the date of death; it was irrelevant that the trustee appealed the trial court decision in its favor to the Kansas Supreme Court and the decision was affirmed.

In IRS Letter Ruling 200848009, the IRS ruled that a state court decree construing a transfer at death of "an amount equal to" the decedent's remaining GST exemption as a gift of a fractional share, rather than a pecuniary gift resulting

in recognition of gain on funding of the gift, would not be honored for federal tax purposes; the ruling implicitly concluded that the court decision was inconsistent with applicable state law. In IRS Letter Ruling 200649027, the IRS ruled that a judicial reformation of a net-income charitable remainder unitrust (NIMCRUT) into a regular CRUT would result in the trust failing to satisfy the requirements of IRC §664 because the proposed reformation would not be made for the purposes of correcting a scrivener's error. See §16.20.

A third consideration is whether a joint trust containing community property is revocable after the death of a settlor spouse. See, *e.g.*, *Heaps v Heaps* (2004) 124 CA4th 286, 21 CR3d 239 (discussed in §16.23); *Estate of Powell* (2000) 83 CA4th 1434, 100 CR2d 501 (discussed in §16.25).

A related consideration, even if a change to the terms of a trust is not tax motivated, is whether there will be unintended tax consequences. For example, will a change in a beneficiary's rights result in a gift by that beneficiary?

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§16.4 4. Alternatives to Modification

Before incurring the expense of a court petition, the attorney for the trustee should determine whether other alternatives are available to accomplish the same goal:

- *Disclaimer.* Can a timely disclaimer (within 9 months of transfer) solve the problem? For example, if a qualified terminable interest property (QTIP) election for a marital trust is desirable, but the terms of the trust provide for income distributions to the surviving spouse and child, will the child disclaim his or her income interest?
- *Interpretation.* Can the document be read to allow what is desired? In particular, consider the effect of the "savings clauses" in the Probate Code (*e.g.,* Prob C §§16100-16105 regarding charitable deductions; Prob C §§21500-21526 regarding marital deductions). See also discussion at §§16.19-16.20 regarding special modification provisions for marital and charitable deduction trusts.
- *Internal modification provisions.* Is there a mechanism for modifying the terms of the trust contained in the document itself? It is becoming more common, particularly in tax-oriented trusts, to find provisions allowing certain amendments, for example, an amendment to conform to changes in the law.

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B. Modification of Revocable Trusts

§16.5 1. Power to Modify Trust

To modify a trust effectively, the settlor must have the same capacity that is needed to execute a trust instrument. Probate Code §15401(c) provides that a trust may be modified by an attorney-in-fact under a power of attorney only if the trust instrument expressly permits such modification. Probate Code §4264(a) provides that the power of attorney must expressly authorize the agent to make modifications to a trust. See discussion at §16.29 regarding revocation by an attorney-in-fact (revocation and modification handled identically).

Trusts governed by California law are revocable unless the trust instrument states otherwise. Prob C §15400. Under Prob C §15402, a settlor who can revoke can also modify the trust unless the trust instrument provides otherwise. See also Restatement (Third) of Trusts §63, Comment g (2003). Most revocable living trusts drafted by California lawyers specifically permit both revocation and modification of the instrument and specify the method to be used. See Drafting California Revocable Trusts, chap 20 (4th ed Cal CEB 2003). For discussion of the procedure to modify, see §16.6.

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons)—the trust instruments must prohibit modification without court approval. Cal Rules of Ct 7.903(a)(1), (c)(2).

NOTE: If a trust holds community property, the trust generally will provide that both settlors must act together to modify the trust. This provision is necessary to ensure that the community property transferred into a trust retains its character as community property. See Fam C §761(a). See §16.23 for discussion of the effect of revocation by the surviving spouse after the first spouse's death. If one spouse is incapacitated when modification is sought, a conservator could be appointed and join in the modification with court approval by a petition for substituted judgment under Prob C §2580, or by a single-action proceeding under Prob C §3101 for community property. See Cal Rules of Ct 7.903(c)(2) for trusts created by court order.

Probate Code §2580(b)(11) allows modification as well as revocation of a trust under the substituted judgment provisions. An agent under an appropriately drawn durable power of attorney should be able to provide such approval if the spouse is opposed to the proposed action and modification is expressly permitted by the trust instrument. See Prob C §§4264(a), 4465, 15401(c).

PRACTICE TIP: Some estate planning practitioners include a general power of appointment in a married couple's revocable trust for *each* spouse, and the trust instrument should be consulted to see if such a provision exists. If so, if the amendment relates to the dispositive provisions of the nonincapacitated spouse's share of property at his or her death, then he or she should be able to change the provisions by exercise of the power of appointment rather than by amendment, possibly eliminating the need for appointment of a conservator to provide the joint approval for modification otherwise required.

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§16.6 2. Modification Procedure

Probate Code §15402 makes procedures for modification the same as those for revocation, which are spelled out in Prob C §15401. (Note, however, that the manner of revocation of pre-July 1, 1987, trusts is governed by prior law. See §16.26.) Any method of modification provided in the trust instrument will of course be effective. If the instrument makes the stated method the exclusive method, it must be followed; if it does not, the trust may be modified by a writing, other than a will, signed by the settlor and delivered to the trustee during the settlor's lifetime. Prob C §15401(a)(2). Instruments may require, for example, written, notarized consent of a third party or a specific waiting period before the modification is effective. See, *e.g., Conservatorship of Irvine* (1995) 40 CA4th 1334, 47 CR2d 587, criticized on other grounds in *Huscher v Wells Fargo Bank* (2004) 121 CA4th 956, 961, 18 CR3d 27 (see §6.23). Provisions like these are designed to protect settlors from possible undue influence of people who would like to benefit from the trust assets. The trust instrument may also require the trustee to consent to the modification, or at least to modifications that change the trustee's duties, liabilities, or compensation.

If a settlor modifies the trust but fails to inform the trustee, the modification will not be effective if the trust instrument requires either delivery of the modification to the trustee or the trustee's consent, because the modification will not have been made according to the terms of the governing instrument. If the modification is effective without the requirement of consent or delivery to the trustee, the trustee who has no knowledge of the modification is not responsible for actions taken contrary to the modification. See *Estate of Canfield* (1947) 80 CA2d 443, 181 P2d 732 (trustee presumed to act in good faith).

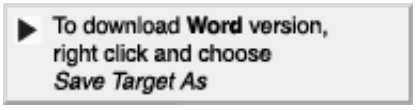
The trustee and his or her attorney should review each modification to make certain it has been executed with the formalities required by the governing instrument and that the instrument as modified can be practicably administered and carries no potential liability. An unworkable modification might be one that required the trustee to render weekly accountings to the settlor, or one that reduces the trustee's compensation to an unacceptable level. A trustee who is unable to or does not wish to act under a modification may reject the modification and will be considered to have rejected it absent an affirmative acceptance. See Prob C §§15600-15601. The trustee presumably would be required to continue to administer the trust without the modification. Prob C §15600(b). The trustee should promptly notify the settlor, in writing, of the rejection (Prob C §15601(a)) so that the latter can act appropriately. Generally, a trustee who simply does not wish to act under an innocuous modification should consider resignation rather than force the settlor to go to the expense of a removal action.

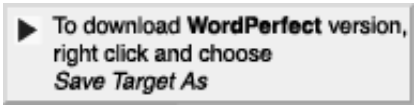
An unresolved legal issue is whether the trustee has an affirmative duty to the settlor to suggest modifications that either conform the trust to changes in the law or make trust administration easier. If unanticipated changed circumstances would cause injury to the trust, Restatement (Third) of Trusts §66(2) (2003) suggests that the trustee is under a duty to petition for the right to deviate from the administrative terms of the trust. The Restatement further suggests that the trustee is similarly under a duty to propose modifications of the distributive provisions if these are necessary to preserve the trust or prevent the defeat of its purposes if the trustee is actually aware that the settlor's purpose would otherwise be frustrated. Restatement (Third) §66(2), Comment e. It is also unsettled whether the trustee's attorney or settlor's attorney, if they are different, has any responsibility to suggest changes and modifications. On review of the governing instrument, the trustee's attorney may suggest modifications that simplify the trust's administration, *e.g.,* adding standard trustee powers rather than relying on implied powers.

For a discussion of modifications versus restatements, see §16.7A.

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§16.7 3. Form: Modification of Trust





_ _[*E.G., SECOND*]_ _ MODIFICATION OF TRUST

_ _[*Name*]_ _ as Settlor and _ _[*name*]_ _ as Trustee have entered into a Trust Agreement dated _ _[*date*]_ _.

Article _ _ _ of the Trust Agreement reserves in Settlor the power to modify the Trust; and

[*Add if applicable*]

The Trust Agreement has been modified by the _ _[*e.g., first*]_ _ modification to the Trust dated _ _[*date*]_ _; and

[*Continue*]

Settlor desires to _ _[*further*]_ _ modify the Trust Agreement, as follows:

1. Article _ _ _ of said Trust Agreement is deleted in its entirety and the following is added:

[*Insert change; repeat clause and insert changes as necessary*]

[*Continue*]

[2.] Settlor confirms all other provisions of the Trust Agreement dated _ _[*date*]_ _, and previous modifications to it.

Executed at _ _ _ _ _ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

[*Notary acknowledgment for settlor*]

I acknowledge receipt of this modification on _ _[*date*]_ _ and consent to its terms.

__[*Signature of trustee*]__
_ _[*Typed name*]_ _

[*Notary acknowledgment for trustee*]

Comment: There is no statutory requirement to notarize or record the trust instrument, but practitioners prefer to have the signatures of the settlors and trustees notarized to authenticate the document. Furthermore, a notary's acknowledgment is necessary if the trust instrument is to be recorded. For further discussion and acknowledgment forms, see §2.65. See also Drafting California Revocable Trusts §19.20 (4th ed Cal CEB 2003).

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§16.7A 4. Restatement Versus Modification

Attorneys have adopted various approaches to determining when to modify a trust in part as opposed to modifying and restating the trust in its entirety. For a form of restatement, see §16.8. There is no rule other than to rely on common sense.

For example, a restatement may be preferable to a partial modification if the trust instrument is becoming difficult to read because of the layers of partial amendments. In this case, a restatement may also resolve any latent ambiguities created by the numerous modifications. A restatement also may be preferable if the change is a sensitive one, because of the documents that must be furnished to the beneficiaries at the settlor's death. When a trust becomes irrevocable due to the death of the settlor, notice must be sent to each trust beneficiary, and each beneficiary is entitled to receive the pertinent terms of the trust on request, including prior amendments that changed the trust terms. Prob C §16061.7. If a trust has been completely restated, however, the superseded instruments or amendments need not be provided. Prob C §16060.5.

Attorneys use various equally acceptable conventions for numbering modifications and restatements. Some attorneys number each change in sequential order, regardless of whether it is a partial or full modification. Others consider each restatement as a new document and number only modifications to that document.

PRACTICE TIP: When a trust is restated in its entirety, it is not necessary to record new trust transfer deeds for real property owned by the settlors if the name of the grantee, *i.e.*, the name of the trustee or the name and date of the trust, remains the same after the restatement and the original trust has not been revoked.

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.8 5. Form: Restatement of Trust in Entirety

§16.8 5. Form: Restatement of Trust in Entirety

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_ _[*E.G., FIFTH*]_ _ MODIFICATION AND RESTATEMENT OF TRUST IN ENTIRETY

_ _[*Name*]_ _ as Settlor and _ _[*name*]_ _, as Trustee have entered into a Trust Agreement dated _ _[*date*]_ _.

Article _ _ _ of the Trust Agreement reserves in Settlor the power to modify the Trust; and

[*Add if applicable*]

The Trust Agreement has been modified by the _ _[*e.g., fourth*]_ _ modification to the Trust dated _ _[*date*]_ _; and

[*Continue*]

Settlor desires to modify and completely restate the Trust Agreement;

Therefore, settlor modifies and completely restates the Trust Agreement as follows:

[*Restate entire trust agreement with changes*]

Executed at _ _ _ _ _ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

[*Notary acknowledgment for settlor*]

I acknowledge receipt of this modification on _ _[*date*]_ _ and consent to its terms.

__[*Signature of trustee*]__
_ _[*Typed name*]_ _

[*Notary acknowledgment for trustee*]

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§16.9 6. Written Directions to Trustee

Some of the purposes of a formal trust modification may be served by a written direction from the settlor to the trustee. Probate Code §16001 requires the trustee of a revocable trust to follow any written direction acceptable to the trustee given by the person having the power to revoke or the person to whom the settlor delegates the right to direct the trustee. This person can be a cotrustee, beneficiary, or third party, *e.g.,* an investment counselor. The trustee may follow the directions without liability to any beneficiary. Prob C §16462.

Probate Code §16001 is presumably intended to protect trustees where trust investment powers are shared or subject to direction, but it permits the settlor to change any of the terms of the trust by written direction instead of by formal modification. If a written direction changes the terms of the trust but does not comply with the requirements for modifying the trust, the trustee has no duty to follow it. Prob C §16001(b).

The trustee likewise need not follow the direction unless it is "acceptable" to the trustee. This provision, in effect, empowers the trustee to require a formal modification if the trustee is uneasy about following the direction. It is not clear whether the trustee has obligations under this phrase. If a direction from a third party changes a specific trust provision, as opposed to an investment direction, the trustee may wish to confirm the direction by consulting the person holding the power to revoke.

PRACTICE TIP: There is no special format for written directions under Prob C §16001. The trustee's attorney should advise the trustee not to accept a direction unless it is dated and signed by the person authorized to direct the trustee. If there are many directions that in effect modify the trust, the trustee may find it difficult to keep track of the terms of the trust. If this occurs, the trustee's attorney should suggest that the directions be combined into a formal trust modification, particularly if the various directions refer to general matters of trust administration, *i.e.,* investment powers or dispositive provisions. A formal trust modification is particularly advisable if the directions are intended to continue in effect when the trust becomes irrevocable.

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C. Modification of Irrevocable Trusts

§16.10 1. When Trust May Be Modified

There are several provisions in the California Probate Code for modification or termination of irrevocable trusts. Assuming the trust does not provide for modification or early termination, trusts may nevertheless be modified or terminated in the following situations:

- All beneficiaries consent (Prob C §15403; see §§16.11-16.14);
- All beneficiaries and the settlor consent (Prob C §15404(a); see §16.15);
- At least one beneficiary and the settlor consent (Prob C §15404(b); see §16.16);
- Principal is uneconomically low (Prob C §15408; see §16.17);
- There are changed circumstances (Prob C §15409; see §16.18); and
- To conform the trust to tax laws (see §§16.19-16.20).

Also, two similar trusts may be combined or a single trust divided, if appropriate. Prob C §§15411-15412.

If none of the statutes apply, a trustee or beneficiary who desires a modification can attempt to get court approval by petitioning for instructions under Prob C §17200(b)(6). For discussion, see §16.11.

Under common law, a settlor can rescind or reform a trust agreement creating an irrevocable trust on the basis of mistake of fact or law if he or she has not received consideration for its creation. *Walton v Bank of Cal.* (1963) 218 CA2d 527, 32 CR 856. The discussion in *Walton* underscored the contractual nature of the trust agreement. See also *Bilafer v Bilafer* (2008) 161 CA4th 363, 73 CR3d 880 (settlor has standing under common law as provided in Prob C §15002 to petition the court to modify an irrevocable trust because of drafting errors).

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2. Consent of All Beneficiaries

§16.11 a. When Beneficiaries May Compel Modification

Under Prob C §15403, if all beneficiaries consent, they may "compel" modification or termination of an irrevocable trust on petition, with two exceptions:

- If, as a question of fact determined by the court, "continuance of the trust is necessary to carry out a material purpose of the trust" and the reason for modifying or terminating does not, in the court's discretion, outweigh the purpose; or
- If the trust includes a spendthrift clause (compare this with other methods of modification or termination).

A spendthrift clause is a valid restraint on the transfer of the beneficiary's interest. See *Leonardini v Wells Fargo Bank & Union Trust Co.* (1955) 131 CA2d 9, 280 P2d 81; *Fletcher v Los Angeles Trust & Sav. Bank* (1920) 182 C 177, 187 P 425.

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§16.12 b. Obtaining Consent of Beneficiaries Who Lack Capacity or Are Unborn or Unascertained

In most situations, it is difficult, if not impossible, to obtain the consent of "all beneficiaries." This is because, at any given time, a trust has remainder or contingent beneficiaries who are minors, unborn, or unascertainable. To address the problem of obtaining the consent of beneficiaries who lack legal capacity or who are unborn or unascertained, a court may appoint a guardian ad litem. If the interests of such beneficiaries conflict, several guardians ad litem may be required. Appointment of guardians ad litem can, therefore, involve significant time and expense.

Some relief from the "all beneficiaries" requirement can be found in Prob C §15404(c), which provides that, if the trust allows for the disposition of principal to a class such as "heirs" or "next of kin," the court may limit the class whose consent is needed to those likely to receive distribution of trust assets. However, there is no case authority that the court discretion to limit consent under Prob C §15404(c) applies to petitions for reformation based on the consent of all beneficiaries without the participation of the settlor. See Love & Temmerman, *Is There a New Trust Code in California's Future? A Comparison of the Recently Adopted Uniform Trust Code with Current California Trust Laws*, 6 Cal Tr & Est Q No. 4 (Winter 2000) (suggesting that adoption of Article 3 of the Uniform Trust Code incorporating the doctrine of virtual representation could eliminate the need for a guardian ad litem for the purpose of consent).

Another provision that helps in defining persons from whom consent must be obtained is Prob C §15406, which provides that the presumption of fertility is rebuttable, permitting a showing that it is unlikely that an older beneficiary will have more children.

Depending on the nature of the modification sought, it may be that the now-living adult beneficiaries adequately represent the interests of all beneficiaries. For example, if the modification relates to the succession-of-trusteeship provisions, all beneficiaries arguably share the same interest in seeing that an appropriate trustee is serving and therefore the interests of minor, unborn, and unascertained beneficiaries are adequately represented by the current beneficiaries. See §16.13 for an ex parte petition under Prob C §15403 (all beneficiaries consenting) based on the consent of current and *presumed* remainder beneficiaries and the allegation that they adequately represent any other beneficiaries.

PRACTICE TIP 1: There may be conflicting interests among living members of the beneficiary's family. An early termination of a trust that would direct a distribution equal to a lifetime interest to a surviving spouse and a remainder interest to a child, based on current actuarial tables, will adversely affect the interest of a grandchild, who would have been entitled to a distribution had the trust remained in force and had the grandchild's surviving parent died before his or her grandparent. Note, however, that under Prob C §15405, the guardian may rely on "general family benefit accruing to living members of the beneficiary's family as a basis for approving a modification or termination of the trust." But see *Boys & Girls Club v Walsh* (2008) 169 CA4th 1049, 87 CR3d 413 (trial court did not abuse its discretion when it modified a trust in accordance with the agreement of all beneficiaries despite the fact that the objecting trustees had the power to name additional beneficiaries; modification permitted distribution of trust to charities without further delay and thereby accomplished the settlor's primary purpose).

PRACTICE TIP 2: In general, because of conflicts between current and remainder beneficiaries and the difficulty of adequately representing the conflicting interests of various minor, unborn, and unascertained beneficiaries by appropriate guardians ad litem, it is often impractical to modify a trust by attempting to obtain the consent of "all beneficiaries." A more efficient approach is to convince the court to modify the trust because of the existence of changed circumstances. See Prob C §§15408-15409; §16.18. The court, however, will generally deny a petition to modify a trust in a manner that would defeat or substantially impair the accomplishment of the settlor's intentions and reasons for establishing the trust.

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.13 c. Form: Ex Parte Petition for Order Modifying Trust Terms

§16.13 c. Form: Ex Parte Petition for Order Modifying Trust Terms

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ROBERT SMITH

SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF SAN FRANCISCO

In the Matter of THE TRUST AGREEMENT dated _ _[*date*]_ _ for the benefit of Smith family members	**Case No. _ _ _ _ _ _** **EX PARTE PETITION FOR ORDER APPROVING MODIFICATION OF TRUST TERMS UNDER PROBATE CODE SECTION 15403 (PROB C §17200(b)(13))**

Petitioner, ROBERT SMITH, alleges:

A. Introduction; Parties; Venue and Jurisdiction.

1. Introduction. Petitioner, the current sole Trustee of an irrevocable trust created by the father of his predeceased wife for benefit of such wife and her descendants, seeks by this petition to modify the Trust terms to provide for a smooth transition of the trusteeship at his death or incapacity. Petitioner is *not* requesting that any of the provisions governing distribution, management, or other administration be modified. All now-living current and presumed remainder beneficiaries have given their written consent to the proposed modification.

2. Parties. On _ _[*date*]_ _ HOWARD PRICE (now deceased), as Trustor, executed a Trust Agreement (the "Trust Agreement") for his benefit during his lifetime, then for the benefit of his only daughter (also now deceased), JANE PRICE SMITH, during her lifetime and then for the benefit of CHARLES SMITH and MARK SMITH, the children of JANE PRICE SMITH (Trustor's grandchildren), during their joint lifetimes. Trustor HOWARD PRICE died on August 31, 1958, and JANE PRICE SMITH died on October 1, 1997; the Trust is currently being administered for the benefit of CHARLES SMITH and MARK SMITH, both of whom are adults in their 60s. The initial Trustees were JANE PRICE SMITH and her husband, ROBERT SMITH (who, at the time of JANE PRICE SMITH's death, had been married for more than 50 years).

A copy of the Trust Agreement is attached hereto as EXHIBIT A and incorporated herein by reference. There have been no modifications, amendments, or revocations to the Trust Agreement as of this date, and the document attached as EXHIBIT A is the currently operative trust instrument.

3. Jurisdiction and Venue. This petition concerns the internal affairs of the Trust, giving this Court subject matter jurisdiction under California Probate Code §17000. The day-to-day administration of the Trust is conducted in San Francisco, California, in the City and County of San Francisco, making venue in this county proper under California Probate Code §17005.

B. Relevant Trust Provisions.

1. Distribution of Income and Principal; Termination. The Trust Agreement requires that all income be paid equally to CHARLES SMITH and MARK SMITH; if one of them is deceased, his share of the income is to be paid to his descendants by right of representation. If a beneficiary should be incompetent, the Trustee is also directed, in the Trustee's absolute discretion, to apply as much principal for such beneficiary's use and benefit as the Trustee deems necessary.

At the death of the last to die of CHARLES SMITH and MARK SMITH, the Trust will terminate and be distributed to each one's then-living descendants, by right of representation. In the event there are no then-living descendants, the Trust is distributable to HOWARD PRICE's heirs at law.

Currently, the descendants of CHARLES SMITH and MARK SMITH (and the presumed remaindermen) are their children, all of whom are adults and are now living, as follows:

Charles:	**PHYLLIS SMITH**
	SAMUEL SMITH
Mark:	**ANN SMITH**
	ALEXANDER SMITH
	ADAM SMITH

2. Trustee Provisions. ARTICLE VIII of the Trust Agreement provides that

The Trustees named herein *[JANE PRICE SMITH and ROBERT SMITH]* **shall have the right to resign at any time, and on such resignation Trustor** *[HOWARD PRICE]* **shall appoint a successor Trustee; provided if the said MARK SMITH and CHARLES SMITH, or their survivor, shall have reached their 21st birthday, said person or persons shall be appointed successor Trustee. In the event of the inability or unwillingness of any of the named Trustees to act, then any beneficiary of the Trust may secure the appointment of a successor Trustee by a court of competent jurisdiction at the expense of the Trust. It is suggested that Wells Fargo Bank and Union Trust company be such successor Trustee.**

C. Authority for Modification of Trustee Provisions; Consents; No Need for Guardian Ad Litem.

Under Probate Code §15403, if all beneficiaries of an irrevocable trust consent, they may compel modification of an otherwise irrevocable trust on petition to the Court. The current beneficiaries (CHARLES SMITH and MARK SMITH) and the presumed remainder beneficiaries (PHYLLIS SMITH, SAMUEL SMITH, ANN SMITH, ALEXANDER SMITH, and ADAM SMITH) have all consented to the modifications described below and requested herein as evidenced by their respective consents attached hereto as EXHIBIT B-1 through EXHIBIT B-7 and incorporated herein by reference. The presumed remainder beneficiaries' interest in the Trust and in the subject matter of this petition are identical to those of their issue and the Trustor's other unborn issue, and therefore, such unborn issue and other unascertained beneficiaries are adequately represented by the presumed remainder beneficiaries and no guardian ad litem is needed.

D. Requested Modification.

Because the language in the Trust Agreement regarding successor Trustees is ambiguous as it applies to the trusteeship if and when Petitioner fails or ceases to serve as Trustee, Petitioner proposes to modify the Trust Agreement to clarify that CHARLES SMITH and MARK SMITH shall serve as Cotrustees on HOWARD PRICE's death or incapacity, and to provide for the succession of the trusteeship thereafter. Avoiding a vacancy in the trusteeship is in the best interests of the beneficiaries of the Trust.

Petitioner requests that Article VIII of the Trust Agreement be deleted in its entirety, to be replaced by the following Article VIII:

A. JANE PRICE SMITH and ROBERT SMITH shall serve as initial Trustees, and if one of them shall fail or

cease to serve, the other shall serve as successor sole Trustee.

B. If both JANE PRICE SMITH and ROBERT SMITH shall fail or cease to serve as Trustee, then CHARLES SMITH and MARK SMITH shall serve as successor Cotrustees; if one of CHARLES SMITH and MARK SMITH shall fail to qualify or cease to serve, then the other shall serve as sole Trustee.

C. While both CHARLES SMITH and MARK SMITH are serving as Cotrustees, they shall have the power, acting jointly, to appoint any individual(s) or institution(s) as the successor Trustee or Cotrustees, and if only one of them is serving as Trustee, then he shall have such power. MARK SMITH and/or CHARLES SMITH, as the case may be, may from time to time revoke any appointment of any successor to him or them before such person or persons or institution assumes office hereunder and may designate the same or another person or persons or institution in any order as successor. All such appointments or revocations hereunder shall be exercised in writing. If both CHARLES SMITH and MARK SMITH shall fail to qualify or cease to serve as Trustee, then the person appointed by them under the foregoing power shall serve as Trustee.

D. If no appointment is made under Article VIII.C. above, then the Trustee shall be the person or institution appointed unanimously by those then living and competent of PHYLLIS SMITH, SAMUEL SMITH, ANN SMITH, ALEXANDER SMITH, and ADAM SMITH. Such appointment shall be exercised in writing.

E. Notice.

The persons to whom notice of this petition should be provided under Probate Code §17203 would be all Trustees and all beneficiaries, as follows:

Trustee:	**ROBERT SMITH** _ _[*address*]_ _
Beneficiaries:	
Current:	**CHARLES SMITH** _ _[*address*]_ _
	MARK SMITH _ _[*address*]_ _
Presumed Remainder	**PHYLLIS SMITH** _ _[*address*]_ _
	SAMUEL SMITH _ _[*address*]_ _
	ANN SMITH _ _[*address*]_ _
	ALEXANDER SMITH _ _[*address*]_ _
	ADAM SMITH _ _[*address*]_ _

Each of the above beneficiaries has waived notice of hearing (EXHIBIT B-1 through EXHIBIT B-7). There are no requests for special notice on file herein.

WHEREFORE, Petitioner prays for an order of this Court:

A. Dispensing with notice of hearing;

B. Determining that, with respect to this petition the interests of any unborn and unascertained beneficiaries are adequately represented without appointment of a guardian ad litem;

C. Approving the modification of Article VIII of the Trust Agreement as set forth above governing the succession of Trustees; and

D. For additional orders as the Court deems proper.

Date: _ _ _ _ _ _ __[*Signature*]__
ROBERT SMITH
SMITH and JONES

By Robert Smith
_____
Attorneys for Petitioners

VERIFICATION

The undersigned says:

I am the Petitioner in the above-entitled matter. I have read the foregoing petition and know its contents, and the same is true of my knowledge, except for the matters that are stated therein on my information and belief, and regarding those matters I believe it to be true.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct, and that this declaration is executed on _ _[*date*]_ _, at _ _[*city*]_ _, California.

__[*Signature*]__
ROBERT SMITH

EXHIBIT B-1: Consent by Charles Smith to Modification of Trust Terms and Waiver of Notice on Petition

I, CHARLES SMITH, declare that I am one of the two current beneficiaries of the above-entitled Trust and that I have read the petition for Order Approving Modification of Trust Terms Under Probate Code §15403 (the "petition") and know its contents. I consent to the modifications requested in the petition. I waive notice of any hearing on the petition.

Date: _ _ _ _ _ _ __[*Signature*]__
CHARLES SMITH

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.14 d. Form: Order Approving Modification of Trust Terms

§16.14 d. Form: Order Approving Modification of Trust Terms

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF SAN FRANCISCO

In the Matter of THE TRUST AGREEMENT dated _ _[*date*]_ _ for the benefit of Smith family members	**Case No. _ _ _ _ _ _** **ORDER APPROVING MODIFICATION OF TRUST TERMS UNDER PROBATE CODE SECTION 15403 (PROB C §17200(b)(13))**

The verified petition of ROBERT SMITH, Trustee of the Trust Agreement dated _ _[*date*]_ _, for the benefit of the Smith family members, for an order approving modification of the Trust terms, came before this Court for ex parte consideration on this date. The Court, having proper jurisdiction, being duly advised of all the facts and law, and having the consent to such modification from all interested persons, finds as follows:

1. Parties; Venue and Jurisdiction.

Parties. On _ _[*date*]_ _, HOWARD PRICE (now deceased), as Trustor, executed a Trust Agreement (the "Trust Agreement") for his benefit during his lifetime, then for the benefit of his only daughter (also now deceased), JANE PRICE SMITH, during her lifetime and then for the benefit of CHARLES SMITH and MARK SMITH, the children of JANE PRICE SMITH (Trustor's grandchildren), during their joint lifetimes. Trustor HOWARD PRICE died on August 31, 1958, and JANE PRICE SMITH died on October 1, 1997; the Trust is currently being administered for the benefit of CHARLES SMITH and MARK SMITH, both of whom are adults in their 60s. The initial Trustees were JANE PRICE SMITH and her husband, ROBERT SMITH (who, at the time of JANE PRICE SMITH's death, had been married for more than 50 years).

There have been no modifications, amendments, or revocations to the Trust Agreement as of this date, and a copy of the _ _[*date*]_ _, Trust Agreement was filed with the Trustee's petition herein.

Jurisdiction and Venue. This petition concerns the internal affairs of the Trust, giving this Court subject matter jurisdiction under California Probate Code §17000. The day-to-day administration of the Trust is conducted in San Francisco, California, in the City and County of San Francisco, making venue in this county proper under California Probate Code §17005.

2. Relevant Trust Provisions.

Beneficiaries. The Trust Agreement requires that all income be paid equally to CHARLES SMITH and MARK SMITH; if one of them is deceased, his share of the income is to paid to his descendants by right of representation. Currently, the descendants of CHARLES SMITH and MARK SMITH (and the presumed remaindermen) are their children, all of whom are adults and are now living, as follows:

Charles: **PHYLLIS SMITH**

SAMUEL SMITH

Mark: **ANN SMITH**

ALEXANDER SMITH

ADAM SMITH

At the death of the last to die of CHARLES SMITH and MARK SMITH, the Trust will terminate and be distributed to each one's then-living descendants, by right of representation. In the event there are no then-living descendants, the Trust is distributable to HOWARD PRICE's heirs at law.

Trustee Provisions. ARTICLE VIII of the Trust Agreement provides that:

The Trustees named herein [JANE PRICE SMITH and ROBERT SMITH] shall have the right to resign at any time and, on such resignation, Trustor [Howard Price] shall appoint a successor Trustee; provided that, if the said MARK SMITH or CHARLES SMITH, or the survivor of them, shall have reached their twenty-first birthday, said person or persons shall be appointed successor Trustee. If any of the named Trustees are unable or unwilling to act, then any beneficiary of the Trust may secure the appointment of a successor Trustee by a court of competent jurisdiction at the expense of the Trust. It is suggested that Wells Fargo Bank and Union Trust company be such successor Trustee.

3. Consents; No Need for Guardian Ad Litem.

The current beneficiaries (CHARLES SMITH and MARK SMITH) and the presumed remainder beneficiaries (PHYLLIS SMITH, SAMUEL SMITH, ANN SMITH, ALEXANDER SMITH, and ADAM SMITH) have all consented to the modifications requested, and their consents are on file herein. The presumed remainder beneficiaries' interest in the Trust and in the subject matter of this petition are identical to those of their issue and the Trustor's other unborn issue, and therefore, such unborn issue and other unascertained beneficiaries are adequately represented by the presumed remainder beneficiaries and no guardian ad litem is needed.

4. Modification.

Because the language in the Trust Agreement regarding successor Trustees is ambiguous as it applies to the trusteeship if and when Petitioner fails or ceases to serve as Trustee, the Trust Agreement should be modified to clarify that CHARLES SMITH and MARK SMITH shall serve as Cotrustees on ROBERT SMITH's death or incapacity, and to provide for the succession of the trusteeship thereafter. Avoiding a vacancy in the trusteeship is in the best interests of the beneficiaries of the Trust.

5. Waiver of Notice, Special Notice.

The persons to whom notice of this petition should be provided have waived notice and consented to the action requested. There are no requests for special notice on file herein.

IT IS HEREBY ORDERED THAT:

A. Notice of the hearing on the within petition is dispensed with;

B. With respect to the within petition, the interests of any unborn and unascertained beneficiaries are adequately represented without appointment of a guardian ad litem;

C. Article VIII of the Trust Agreement is hereby deleted in its entirety and is replaced with the following Article VIII:

A. JANE PRICE SMITH and ROBERT SMITH shall serve as initial Trustees, and if one of them shall fail or cease to serve, the other shall serve as successor sole Trustee.

B. If both JANE PRICE SMITH and ROBERT SMITH shall fail or cease to serve as Trustee, then CHARLES SMITH and MARK SMITH shall serve as successor Cotrustees; if one of them shall fail to qualify or cease to serve, then the other shall serve as sole Trustee.

C. While both CHARLES SMITH and MARK SMITH are serving as Cotrustees, they shall have power, acting jointly, to appoint any individual(s) or institution(s) as the successor Trustee or Cotrustees, and if only one of them is serving as Trustee, then he shall have such power. MARK SMITH and/or CHARLES SMITH, as the case may be, may from time to time revoke any appointment of any successor to him or them prior to such person or persons or institution assuming office hereunder and may designate the same or another person or persons or institution in any order as successor. All such appointments or revocations hereunder shall be exercised in writing. If both CHARLES SMITH and MARK SMITH shall fail to qualify or cease to serve as Trustee, then the person appointed by them under the foregoing power shall serve as Trustee.

D. If no appointment is made under Article VIII.C. above, then the Trustee shall be the person or institution appointed unanimously by those then living and competent of PHYLLIS SMITH, SAMUEL SMITH, ANN SMITH, ALEXANDER SMITH, and ADAM SMITH. Such appointment shall be exercised in writing.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

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§16.15 3. Consent of All Beneficiaries and Settlor

If the settlor and all beneficiaries consent, they may "compel" modification or termination of a trust. Prob C §15404(a). This is the case even if a material purpose of the trust cannot be carried out, or the reasons for modifying or terminating are less important, and even if there is a spendthrift clause protecting one of the beneficiaries. 20 Cal L Rev'n Comm'n Reports 1877 (1990).

Procedurally, assuming that no one objects, there is nothing to bring before a court. If someone objects or the trustee wants an order for protection, the procedure to follow under Prob C §15404(a) is a petition under Prob C §17200(b)(13).

For discussion of obtaining consent of all beneficiaries, see §16.12.

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.16 4. Consent of at Least One Beneficiary and Settlor

§16.16 4. Consent of at Least One Beneficiary and Settlor

Fewer than all beneficiaries, with the consent of the settlor, can compel modification or partial termination of the trust on petition to the court if the interests of the nonconsenting beneficiaries are "not substantially impaired." Prob C §15404(b). Probate Code §15404(c) provides that, if a disposition of principal is to a group of persons who would take under the rules of intestate succession, the court may limit the class whose consent is needed to beneficiaries who are likely to take.

The procedure to follow is a petition under Prob C §17200(b)(13).

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§16.17 5. Existence of Uneconomically Low Principal

Regardless of the beneficiaries' consent or the presence of a spendthrift clause, a trust that cannot be economically administered can be modified or terminated. Probate Code §15408 provides two methods, depending on the amount of principal. If the principal is $20,000 or less, the trustee is empowered to terminate the trust immediately. For full discussion and sample forms, see §§16.37-16.42.

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§16.18 6. Changed Circumstances

The court may modify either administrative or dispositive provisions or terminate the trust "if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust." Prob C §15409(a). The statute further provides that, if necessary to carry out the purposes of the trust, the court may order the trustee "to do acts that are not authorized or are forbidden by the trust instrument." Prob C §15409(a).

In deciding whether to modify or terminate the trust, the court must consider a trust provision restraining transfer of the beneficiary's interest, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer. Prob C §15409(b).

Petitions for modification due to changed circumstances are often seen in the context of charitable trusts. If the trust provides for distributions to a certain charity, and that charity is no longer in existence when the trust comes into being or goes out of existence during the term of the trust, the courts will follow the cy pres doctrine. This allows the court to carry out, as nearly as possible, the purpose of the charitable trust rather than allowing it to fail. See, *e.g., Lynch v Surprise Valley Lodge No. 235* (1972) 26 CA3d 265, 103 CR 1; *Estate of Zahn* (1971) 16 CA3d 106, 93 CR 810. The court will determine whether the settlor's or testator's intent can be accomplished by distributing to another charity of like or similar purposes. Generally, the court will allow substitution of another charity, except when the trust instrument clearly indicates a particular charitable purpose and provides for the trust to fail if that purpose cannot be carried out. Restatement (Third) of Trusts §67 (2003).

The proper procedure under Prob C §15409 is presumably a petition by the trustee or a beneficiary under Prob C §17200(b)(13). The issues appear to be the following:

- What are the purposes of the trust?
- Would the continuation of the trust under its terms defeat or substantially impair their accomplishment?
- If so, is it because of circumstances not known or unanticipated by the settlor?

The court's ability to modify a trust was broadened in *Ike v Doolittle* (1998) 61 CA4th 51, 70 CR2d 887. The court relied in part on Prob C §15002, which states that, except to the extent that common law rules are modified by statute, the common law as to trusts is the law in California. The court then looked to California cases under common law giving courts the power to modify trusts under "peculiar" or "exceptional" circumstances. The court found that drafting errors were such a circumstance and that, because the trust agreement was patently ambiguous, extrinsic evidence was admissible to determine the trustor's intent. It would seem that the court might have reached the same result by relying on Prob C §17200(b)(1), which allows an interested party to bring a petition to determine questions of construction of a trust instrument.

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7. Modification by Court to Conform to Tax Laws

§16.19 a. Charitable Remainder Trust

Recognizing that gifts are often made in trust for tax purposes, the Trust Law is solicitous about the conformity of the instrument to the tax law. Probate Code §§16100-16105 supply terms of the trust that negate any inconsistent provision (Prob C §16104); the terms limit the powers of the trustee to prevent acts that would result in taxation of the income of the trust.

Probate Code §§21540-21541 are rules of construction that apply to charitable trusts. Dealing respectively with charitable remainder unitrusts and annuity trusts and with charitable lead trusts, they provide broadly that the fiduciary shall take no action or have any power that impairs the charitable deduction. These sections and Prob C §17200(b)(15) provide for modification of an irrevocable trust to obtain the charitable deduction if the trust is not in conformance with the tax laws. See Drafting California Irrevocable Trusts §§18.37-18.100 (3d ed Cal CEB 1997) (necessary provisions in a charitable remainder trust). The Attorney General of California must be given notice of any petition to modify a trust affecting a charitable trust subject to his or her jurisdiction. Prob C §17203(a)(3). If the trustee and his or her attorney believe it appropriate to modify the trust instrument, the attorney should advise the beneficiaries of the tax implications, their right to retain independent counsel, and their right to disagree. See Irrevocable Trusts §§18.101-18.105 (reformation of charitable remainder trust).

The trustee should work out agreeable terms with input from the income beneficiaries and charitable remainder beneficiaries. However, the trustee should keep in mind that if the trustee fails to propose the modification to conform the trust as a charitable trust for tax purposes, he or she may be subject to potential surcharge by the charity at a later date for failing to attempt to modify the trust, because the loss of the charitable deduction decreases the amount of principal later available to the charity. In *Estate of Anthony J. Tamulis*, TC Memo 2006-183, aff'd (7th Cir 2007) 509 F3d 343, the court of appeals held that the doctrine of substantial compliance could not be applied to excuse a failure to timely file a state court proceeding to reform a defective charitable remainder trust into a unitrust. (The decision implied that the trust could not be reformed under state law because one of the beneficiaries would not consent to the reformation.) As a result, the court disallowed a $1.5 million charitable deduction for a $3.4 million estate passing to a trust for the benefit of decedent's brother and his wife and several of their children for their joint lives with remainder to charity.

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§16.20 b. Marital Deduction Trust

Probate Code §§21520-21526 provide statutory modifications to salvage an improperly drafted marital deduction provision. If the trustee believes that the settlor's intent was to have a marital deduction but the instrument does not appear to meet the Internal Revenue Code requirements, presumably the trustee should petition the court to confirm that the trust was intended to be a marital deduction trust and to ask for instructions to administer the trust as modified by the provisions of these sections. For the procedures for filing a petition for instructions, see chap 15. In appropriate circumstances, it may not be necessary to petition for instructions and Prob C §§21522-21525 can be used simply to construe the trust terms to comply with the marital deduction provisions of the Internal Revenue Code.

The Probate Code modification provisions can be used to modify the trust only if the settlor's intent to qualify for the marital deduction is evident. See *Estate of Ellingson v Commissioner* (9th Cir 1992) 964 F2d 959. See also *Estate of Cavenaugh v Commissioner* (5th Cir 1995) 51 F3d 597; *Warner v U.S.* (CD Cal 2006) 98 AFTR2d 6136 (trust included in surviving spouse's estate as QTIP property under IRC §2044 because decedent's intent that trust income should be paid to spouse at least annually could be inferred). Even if the intent to qualify is evident, Prob C §§21522-21525 may not salvage the marital deduction provision if the trust contains dispositive provisions that would disqualify the trust for the marital deduction. See, *e.g.*, IRS Letter Ruling 200234017 (marital deduction savings clause did not nullify surviving spouse's inter vivos appointment power in QTIP trust). In recent years, however, the IRS has shown an increasing willingness to honor state court reformations of unintended provisions based on scrivener error. See, *e.g.*, IRS Letter Ruling 200201020, involving a trust in which the literal language allowed a child to appoint property to herself even though it was clear that she was intended to have only a nongeneral power of appointment. The Service ruled that the proposed court reformation would be consistent with California state law and would be honored for tax purposes.

Of course, a court proceeding to reform the trust is worthwhile only if significant transfer tax savings can be achieved by qualifying the trust for the marital deduction. With increased exemptions from the estate tax, this may not be the case. For example, in most cases the surviving spouse already owns one-half of the couple's property as community or quasi-community property, and this is not subject to taxation in the deceased spouse's estate. The exemption amount is $3.5 million in 2009 (decreasing to $1 million in 2011). IRC §2010(c). Therefore, if a married person dies in 2009 with combined assets of $7.1 million, only $100,000 would pass to the marital deduction qualifying trust under a typical reduce-to-zero estate plan and be subject to the imposition of estate tax if nothing is done to reform the trust. Alternatives, such as a filing a disclaimer so that the trust property passes outright to the surviving spouse or paying interest to a pecuniary bypass trust on delayed distribution, should be explored. For discussion of interest payments on the pecuniary share on the death of the first spouse, see §14.44.

Trust modification also may be necessary for a trust intended to qualify for the marital deduction if the surviving spouse is not a citizen of the United States. See §§16.20A-16.20D.

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§16.20A 8. Need for Trust Reformation When Surviving Spouse Is Not U.S. Citizen

A special problem will occur when the trust does not take into account the fact that the beneficiary is a surviving spouse who is not a citizen of the United States. Normally, there is an unlimited marital deduction for qualifying gifts in trust to the decedent's spouse. See chap 12. This deduction is denied if the surviving spouse is not a citizen of the United States. IRC §2056(d)(1). Congress restricted the marital deduction for noncitizens out of concern that such beneficiaries might return to their homelands after receiving the deduction, thus depriving the United States of the estate tax that would have been collected had the noncitizen beneficiary surviving spouse remained a resident of this country.

There is an exception to disallowance, however, if the gift is to be held for the noncitizen spouse in a qualified domestic trust (QDOT). IRC §§2056(d)(2)(A), 2056A. See Drafting California Revocable Trusts §§13.27-13.33 (4th ed Cal CEB 2003). The deduction also is allowed if the noncitizen spouse becomes a citizen before the due date for filing the return, including extensions, which can be up to 15 months after the decedent's death. IRC §2056(d)(4). If the surviving spouse will not become a citizen, the marital deduction qualifying trust can be reformed to qualify as a QDOT. See §16.20B.

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§16.20B a. Reformation of Trust to Qualify as QDOT

If the trust intended to qualify for the marital deduction as drafted does not include the necessary language for a qualified domestic trust (QDOT), then a petition may be used to reform the trust. If judicial proceedings to reform the trust are commenced before the final due date for the return, including extensions, then the judicial reformation can be completed after the due date. IRC §2056(d)(5). See §12.46. The preamble to IRC §2032 regulations concerning alternate valuation date elections also permits applications to make late QDOT elections if the estate tax return is filed no later than 1 year after the due date of the return (including extensions of time actually granted). TD 9172, 70 Fed Reg 295 (Jan. 4, 2005). (The QDOT regulations have not yet incorporated the IRS position.)

PRACTICE TIP: The surviving noncitizen spouse also can obtain a marital deduction for property passing from the deceased spouse to himself or herself outside the trust by creating an irrevocable trust with the required QDOT provisions and making the appropriate transfer or assignment of the property to the trust. IRC §2056(d)(2)(B). See Drafting California Irrevocable Trusts §§2.81-2.81G (3d ed Cal CEB 1997).

Under certain circumstances (by including provisions in the decedent's trust agreement permitting the trustee to reform the trust), the trustee may be able to reform the trust unilaterally to qualify as a QDOT without the necessity of a costly court-ordered reformation. See Treas Reg §20.2056A-4(a)(1). For a sample trust clause, see Drafting California Revocable Trusts §13.33, alternative 2 (4th ed Cal CEB 2003). In either case, reformation is worthwhile only if significant transfer tax savings can be achieved by qualifying the trust for the marital deduction. This may not be the case if only a small amount of the decedent's property will be allocated to the trust under the marital deduction formula as a result of increased exemption amounts in IRC §2010(c).

If the settlor's intent to qualify for the marital deduction is evident, then a petition to reform the trust may be filed under the general authority of Prob C §17200 and the marital deduction savings provisions of Prob C §§21520-21526. See §16.20. If the trust already contains provisions for division of the trust into two or more trusts on the death of the first spouse to die, the settlors obviously intended that the benefits of the marital deduction be achieved. A form of petition and judgment for reformation of the trust to qualify as a QDOT are provided in §§16.20C-16.20D.

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§16.20C b. Form: Petition to Reform Trust to Qualify as QDOT

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_ _[*Name and address of counsel*]_ _
Attorneys for Petitioner

SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In the Matter of the Trust Agreement dated _ _[*date*]_ _, establishing _ _[*name*]_ _ Living Trust by and between _ _[*name*]_ _, Deceased, and her husband as Trustors and the initial Trustees	**Case No. _ _ _ _ _ _** **PETITION FOR REFORMATION OF TRUST AGREEMENT (PROB C §§21520-21526)** **Hearing Date:** _ _[*date*]_ _ **Time:** _ _[*time*]_ _ **Dep't:** _ _[*number*]_ _ **Judge:** _ _[*if known*]_ _

Petitioner respectfully alleges and petitions:

1. On _ _[*date*]_ _, _ _[*husband*]_ _ and _ _[*wife*]_ _ executed a Trust Agreement entitled the _ _[*name*]_ _ Living Trust by and between themselves as trustors and trustees. A copy of this trust agreement is attached hereto as Exhibit 1, and by this reference made a part thereof.

2. _ _[*Wife*]_ _ died on _ _[*date*]_ _, a resident of _ _[*city*]_ _, California. A probate proceeding for the administration of her estate has not been and will not be commenced. She was married to _ _[*husband*]_ _ when she died. He is her sole current beneficiary under the trust. There are _ _[*number*]_ _ children from the marriage who are vested remaindermen. _ _[*Wife*]_ _ is not survived by siblings or parents. Notice is being sent to the vested remainder beneficiaries and all other interested parties. _ _[*Husband*]_ _ is not a citizen of the United States, but is a permanent resident.

3. Probate Code §17200 provides in pertinent part:

> **(a) Except as otherwise provided in Section 15800, a trustee or beneficiary of a trust may petition the court under this chapter concerning the internal affairs of the trust or to determine the existence of the trust.**
>
> **(b) Proceedings concerning the internal affairs of a trust include, but are not limited to, proceedings for any of the following purposes:**
>
> **(1) Determining questions of construction of a trust instrument.**
>
> **…**
>
> **(13) Approving or directing the modification or termination of the trust.**

Thus, based on the above, the court has the authority to interpret the trust instrument. Furthermore, the power to reform a trust to conform to the settlor's intent is an inherent equitable power of the Superior Court.

Probate Code §§21520-21526 further allow the Superior Court to modify a trust to secure the intended marital deduction.

3. The _ _[*name*]_ _ Living Trust (hereinafter referred to as the "Living Trust") created three trusts upon the death of the first spouse to die:

[*Insert marital, bypass, and survivor trust clauses*]

The clear intent expressed in the paragraphs cited above is that the _ _[*name*]_ _ Trust (hereinafter referred to as the "Marital Trust") qualify for the marital deduction. Pursuant to provisions of Internal Revenue Code §2056, in order to qualify for the marital deduction, the assets of the Living Trust passing to the Marital Trust need to pass to a Qualified Domestic Trust (QDOT) as governed by the principles of Internal Revenue Code section 2056A for the benefit of her husband. Also, California Probate Code §21522 states the legislative intent to preserve the marital deduction and such reformation is in accordance therewith. Therefore the Marital Trust should be reformed to be a Qualified Domestic Trust (QDOT) as governed by the principles of Internal Revenue Code §2056A.

4. The Trustees desire to reform the provisions of the Living Trust in order to comply with federal estate tax regulations for Qualified Domestic Trusts. The initial trustees of the QDOT shall be _ _[*husband*]_ _ and _ _[*name*]_ _, who is a citizen of the United States and as such fulfills the requirement of Internal Revenue Code §2056A(a)(1)(A) that there be at least one trustee who is a citizen of the United States. The Trustees hereby incorporate the provisions, attached hereto entitled, QDOT PROVISIONS INCORPORATED INTO THE _ _[*NAME*]_ _ LIVING TRUST, into the Living Trust and by this reference made a part thereof. These provisions are in addition to those provisions already provided by the Living Trust. If any of the provisions in the Living Trust conflicts with the incorporated provisions, then the Trustees shall interpret the provision in such a way that the Marital Trust qualifies as a QDOT.

The fair market value of assets passing to the Marital Trust (determined without reduction for any indebtedness thereon) will be less than $2,000,000 and the trust assets will not include any real property located outside of the United States. Therefore, no bond will be required by Treasury Regulation §20.2056A-2(d)(1)(i) or (ii). Additionally, the trust instrument waives bond in general, and as such, no bond should be required at this time.

[*Delete above paragraph and modify order if security arrangements are required as described in Attachment to Petition*]

Wherefore, Petitioner prays that the court make its order as follows:

1. That the Trustees of the Living Trust be authorized to make a formula marital deduction for the minimum amount necessary to reduce the deceased spouse's tax to zero;

2. That as a result of the formula election, title to the marital portion of the trust assets be confirmed to the Marital Trust as reformed and restated herein;

3. That no bond is required at this time;

4. For other such orders as the court may deem proper.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for Petitioner

[*Verification; see §7.116*]

ATTACHMENT TO PETITION

QDOT PROVISIONS INCORPORATED INTO THE _ _[*NAME*]_ _ LIVING TRUST

1. It is the settlor's intention that the _ _[*name*]_ _ Trust (hereinafter referred to as the "Marital Trust") created by this instrument shall qualify as a "Qualified Domestic Trust" (QDOT) under the provisions of Internal Revenue Code §2056A, as amended, if qualification as a QDOT is required for the assets of the Marital Trust to qualify for the federal estate tax marital deduction. In that case, the following provisions shall apply for it to qualify as a QDOT:

a. The Marital Trust shall at all times have at least one trustee called the U.S. Trustee who is an individual citizen of the United States or a domestic corporation.

b. If at any time any noncitizen of the United States, or a foreign corporation, is designated to become the

sole trustee under the provisions of this trust, then that person or entity shall not serve as sole trustee, but shall serve as co-trustee along with the person or entity designated as successor trustee under the terms of the trust, if that successor trustee would be a U.S. Trustee. If either (1) this instrument makes no provision for a successor trustee, (2) the designated successor trustee would not be a U.S. Trustee, or (3) all nominations for successor trustee have been exhausted, then the surviving settlor shall petition the court to appoint a U.S. Trustee as successor co-trustee to serve along with the noncitizen or foreign corporation co-trustee. If the Surviving Trustor was to become sole trustee but for the foregoing provisions of this section, and if he or she becomes a citizen of the United States after appointment of another co-trustee, the surviving settlor if he or she so chooses, may remove the other trustee and become the sole trustee.

2. No distribution (other than a distribution of income) may be made from the Marital Trust unless the U.S. trustee has the right to withhold from that distribution the tax imposed by the Internal Revenue Code §2056A on that distribution. The U.S. Trustee is hereby granted the power to withhold that tax from any such distribution.

3. The trustee shall comply with the requirements for security arrangements for qualified domestic trusts as set forth in Treasury Regulation §20.2056A-2(d)(1)(i) or (ii), summarized as follows:

a. *Trust in Excess of $2 Million*. If the fair market value of the assets passing to the Marital Trust (determined without reduction for any indebtedness thereon) exceeds $2 million on the relevant valuation date, then the trustee must at all times during the term of the trust either satisfy the U.S. Bank as Trustee requirement (see Treasury Regulation §20.2056A-2(d)(1)(i)(A)), or furnish a bond that satisfies the requirements of Treasury Regulation §20.2056A-2(d)(1)(i)(B), or furnish an irrevocable letter of credit that satisfies the requirements of Treasury Regulation §20.2056A-2(d)(1)(i)(C) (hereinafter referred to as the U.S. Bank, Bond, or Letter of Credit Requirement). The trustee may alternate between any of the security arrangements described in the preceding sentence provided that, at all times during the term of the trust, one of the arrangements is operative.

If the trustee elects to furnish a bond or letter of credit as security, then in the event the Internal Revenue Service draws on the instrument in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15th of the calendar year following the year in which the bond or letter of credit is drawn upon.

b. *Trust of $2 Million or Less*. If the fair market value of the assets passing to the Marital Trust (determined without reduction for any indebtedness) is $2 million or less on the relevant valuation date, then the trustee must comply with the U.S. Bank, Bond, or Letter of Credit Requirement only if more than 35 percent of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust, consists of real property located outside the United States. For purposes of determining whether more than 35 percent of the trust assets consist of foreign real property, the look-through rule of Treasury Regulation §20.2056A-2(d)(1)(ii)(B) applies.

c. *Determination of Value.* For purposes of determining whether the fair market value of the trust assets exceeds $2 million, the trustee is authorized to make the election under Treasury Regulations §20.2056A-2(d)(1)(iv)(A) with respect to real property used as the surviving settlor's personal residence.

d. *Amount of Bond or Letter of Credit*. For purposes of determining the amount of the bond or letter of credit, the trustee is authorized to make the election under Treasury Regulation §20.2056A-2(d)(1)(iv)(B) with respect to real property used as the surviving settlor's personal residence.

e. *Annual Statements.* The trustee is directed to file any annual statements required under Treasury Regulations §20.2056A-2(d)(3).

f. *General Conduct.* Notwithstanding anything contained herein to the contrary, the U.S. Trustee is hereby authorized to enter into alternative plans or arrangements with the Internal Revenue Service pursuant to Treasury Regulation §20.2056A-2(d)(4) to assure collection of the deferred estate tax, in lieu of the provisions contained in this section of the instrument.

4. The trustee, acting in lieu of an executor as provided in Internal Revenue Code section 2203, is authorized to make the election to qualify the Marital Trust as a QDOT in the manner prescribed by law. However, this subsection shall not be construed as affecting the executor's power to make or not to make an estate tax QTIP election under Internal Revenue Code §2056(b)(7) with respect to some or all of the amount that may qualify for

the marital deduction.

5. The Marital Trust shall meet all requirements prescribed by the Secretary of the Treasury by regulations from time to time to ensure the collection of the tax imposed by Internal Revenue Code §2056A. The trustee is authorized to amend and reform the terms of this instrument whenever necessary to comply with those regulations or otherwise to assure that the trust will qualify for the marital deduction as a QDOT under applicable law.

Comment: For examples of typical marital, bypass, and survivor trust clauses, see Drafting California Revocable Trusts, chaps 9-14 (4th ed Cal CEB 2003).

The QDOT provisions in the Attachment to Petition are taken from provisions of Treas Reg §20.2056A-2. The regulation should be reviewed to see if any changes are required before the petition is filed.

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§16.20D c. Form: Judgment Reforming Trust to Qualify as QDOT

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_ _[*Name and address of counsel*]_ _
Attorneys for Petitioner

SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

In the Matter of the Trust Agreement dated _ _[*date*]_ _, establishing The _ _[*name*]_ _ Living Trust by and between _ _[*name*]_ _, Deceased, and her husband as Trustors and the initial Trustees	**Case No. _ _ _ _ _ _** **JUDGMENT ON MODIFICATION OF TRUST AGREEMENT**

The Petition of _ _[*name(s) of petitioner(s)*]_ _, came on for hearing on _ _[*date*]_ _. The court finds as follows:

1. On _ _[*date*]_ _, _ _[*husband*]_ _ and _ _[*wife*]_ _ executed a Trust Agreement entitled the _ _[*name*]_ _ Living Trust (hereinafter referred to as the "Living Trust") by and between themselves as trustors and trustees.

2. _ _[*Wife*]_ _ died on _ _[*date*]_ _, a resident of _ _[*city*]_ _, California. A probate proceeding for the administration of her estate has not been and will not be commenced. She was married to _ _[*husband*]_ _ when she died. He is her sole current beneficiary under the trust. There are _ _[*number*]_ _ children from the marriage who are vested remaindermen. _ _[*Wife*]_ _ is not survived by siblings or parents. Notice has been sent to the vested remainder beneficiaries and all other interested parties. _ _[*Husband*]_ _ is not a citizen of the United States, but is a permanent resident.

3. Probate Code §17200 provides in pertinent part:

> **(a) Except as otherwise provided in Section 15800, a trustee or beneficiary of a trust may petition the court under this chapter concerning the internal affairs of the trust or to determine the existence of the trust**
>
> **(b) Proceedings concerning the internal affairs of a trust include, but are not limited to, proceedings for any of the following purposes:**
>
> **(1) Determining questions of construction of a trust instrument.**
>
> **…**
>
> **(13) Approving or directing the modification or termination of the trust.**

Thus, based on the above, the court has the authority to interpret the trust instrument. Furthermore, the power to modify a trust to conform to the settlor's intent is an inherent equitable power of the Superior Court.

Probate Code §§21520-21526 further allow the Superior Court to modify a trust to secure the intended marital deduction.

4. The Living Trust made provisions for a trust that would qualify for the marital deduction if the surviving spouse was a citizen of these United States. However, the surviving spouse is not. The clear intent expressed in the Living Trust is that the _ _[*name*]_ _ Trust (hereinafter referred to as the "Marital Trust") qualify for the marital deduction. Pursuant to provisions of Internal Revenue Code §2056(d)(2), in order to qualify for the marital deduction, the assets of wife's estate passing to the Marital Trust must pass to a Qualified Domestic

Trust (QDOT) as is governed by the principles of Internal Revenue Code section 2056A for the benefit of her husband. Also, California Probate Code §21522 states the legislative intent to preserve the marital deduction and such modification is in accordance therewith.

5. The Trustees desire to modify the provisions of the Living Trust to comply with federal estate tax regulations for Qualified Domestic Trusts. The initial trustees of the QDOT shall be _ _[*husband*]_ _ and _ _[*name*]_ _, who is a citizen of the United States and as such fulfills the requirement of Internal Revenue Code §2056A(a)(1)(A) that there be at least one trustee who is a citizen of the United States. If any of the provisions in the Living Trust conflicts with the provisions of this Judgment, then the Trustees shall interpret the provision in such a way that the trust qualifies as a QDOT.

6. The fair market value of assets passing to the Marital Trust (determined without reduction for any indebtedness thereon) will be less than $2,000,000 and the trust assets will not include any real property located outside of the United States. Therefore, no bond is required by Treasury Regulation §20.2056A-2(d)(1)(i) or (ii). Additionally, the trust instrument waives bond in general, and as such, no bond should be required at this time.

WHEREFORE, the court orders:

1. That the Trustees of the Living Trust be authorized to make a formula marital deduction for the minimum amount necessary to reduce the deceased spouse's tax to zero;

2. That as a result of the formula election, title to the marital portion of the trust assets be confirmed to the Marital Trust as modified and restated herein;

3. That no bond is required at this time;

4. That the Living Trust is modified as follows:

QDOT PROVISIONS INCORPORATED INTO THE _ _[*NAME*]_ _ LIVING TRUST

1. It is the settlor's intention that the _ _[*name*]_ _ Trust (hereinafter referred to as the "Marital Trust") created by this instrument shall qualify as a "Qualified Domestic Trust" (QDOT) under the provisions of Internal Revenue Code §2056A, as amended, if qualification as a QDOT is required for the assets of the Marital Trust to qualify for the federal estate tax marital deduction. In that case, the following provisions shall apply for it to qualify as a QDOT:

a. The Marital Trust shall at all times have at least one trustee called the U.S. Trustee who is an individual citizen of the United States or a domestic corporation.

b. If at any time any noncitizen of the United States, or a foreign corporation, is designated to become the sole trustee under the provisions of this trust, then that person or entity shall not serve as sole trustee, but shall serve as co-trustee along with the person or entity designated as successor trustee under the terms of the trust, if that successor trustee would be a U.S. Trustee. If either (1) this instrument makes no provision for a successor trustee, (2) the designated successor trustee would not be a U.S. Trustee, or (3) all nominations for successor trustee have been exhausted, then the surviving settlor shall petition the court to appoint a U.S. Trustee as successor co-trustee to serve along with the noncitizen or foreign corporation co-trustee. If the Surviving Trustor was to become sole trustee but for the foregoing provisions of this section, and if he or she becomes a citizen of the United States after appointment of another co-trustee, the surviving settlor if he or she so chooses, may remove the other trustee and become the sole trustee.

2. No distribution (other than a distribution of income) may be made from the Marital Trust unless the U.S. trustee has the right to withhold from that distribution the tax imposed by the Internal Revenue Code §2056A on that distribution. The U.S. Trustee is hereby granted the power to withhold that tax from any such distribution.

3. The trustee shall comply with the requirements for security arrangements for qualified domestic trust's as set forth in Treasury Regulation §20.2056A-2(d)(1)(i) or (ii), summarized as follows:

a. *Trust in Excess of $2 Million*. If the fair market value of the assets passing to the Marital Trust (determined

without reduction for any indebtedness thereon) exceeds $2 million on the relevant valuation date, then the trustee must at all times during the term of the trust either satisfy the U.S. Bank as Trustee requirement (see Treasury Regulation §20.2056A-2(d)(1)(i)(A)), or furnish a bond that satisfies the requirements of Treasury Regulation §20.2056A-2(d)(1)(i)(B), or furnish an irrevocable letter of credit that satisfies the requirements of Treasury Regulation §20.2056A-2(d)(1)(i)(C), (hereinafter referred to as the U.S. Bank, Bond, or Letter of Credit Requirement). The trustee may alternate between any of the security arrangements described in the preceding sentence provided that, at all times during the term of the trust, one of the arrangements its operative.

If the trustee elects to furnish a bond or letter of credit as security, then in the event the Internal Revenue Service draws on the instrument in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15th of the calendar year following the year in which the bond or letter of credit is drawn upon.

b. *Trust of $2 Million or Less*. If the fair market value of the assets passing to Trust C (determined without reduction for any indebtedness) is $2 million or less on the relevant valuation date, then the trustee must comply with either the U.S. Bank, Bond, or Letter of Credit Requirement only if more than 35 percent of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust, consists of real property located outside the United States. For purposes of determining whether more than 35 percent of the trust assets consist of foreign real property, the look-through rule of Treasury Regulation §20.2056A-2(d)(1)(ii)(B) applies.

c. *Determination of Value.* For purposes of determining whether the fair market value of the trust assets exceeds $2 million, the trustee is authorized to make the election under Treasury Regulation §20.2056A-2(d)(1)(iv)(A) with respect to real property used as the surviving settlor's personal residence.

d. *Amount of Bond or Letter of Credit*. For purposes of determining the amount of the bond or letter of credit, the trustee is authorized to make the election under Treasury Regulation §20.2056A-2(d)(1)(iv)(B) with respect to real property used as the surviving settlor's personal residence.

e. *Annual Statements.* The trustee is directed to file any annual statements required under Treasury Regulation §20.2056A-2(d)(3).

f. *General Conduct.* Notwithstanding anything contained herein to the contrary, the U.S. Trustee is hereby authorized to enter into alternative plans or arrangements with the Internal Revenue Service pursuant to Treasury Regulation §20.2056A-2(d)(4) to assure collection of the deferred estate tax, in lieu of the provisions contained in this section of the instrument.

4. The trustee, acting in lieu of an executor as provided in Internal Revenue Code §2203, is authorized to make the election to qualify the Marital Trust as a QDOT in the manner prescribed by law. However, this subsection shall not be construed as affecting the executor's power to make or not to make an estate tax QTIP election under Internal Revenue Code §2056(b)(7) with respect to some or all of the amount that may qualify for the marital deduction.

5. The Marital Trust shall meet all requirements prescribed by the Secretary of the Treasury to ensure the collection of the tax imposed by Internal Revenue Code §2056A. The trustee is authorized to modify the terms of this instrument whenever necessary to comply with those regulations or otherwise to assure that the trust will qualify for the marital deduction as a QDOT under applicable law.

Date: _ _ _ _ _ _ **__[*Signature*]__**
Judge of the _ _[*title of court*]_ _

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.21 D. Combining or Dividing Trusts

§16.21 D. Combining or Dividing Trusts

Under Prob C §15411, in order to combine two or more trusts, the terms need be only "substantially similar" and the joint administration must not "defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries." Provisions for dividing trusts in Prob C §15412 are analogous. The procedure for either action is a petition under Prob C §17200(b)(14).

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II. REVOCATION OF TRUST

§16.22 A. Presumption of Revocability in California

If the settlor is domiciled in California when a trust is created, or the trust instrument is executed here or chooses California law, a voluntary trust is revocable unless the trust instrument expressly provides that it is irrevocable. Prob C §15400. This rule is contrary to the common law rule. See Restatement (Third) of Trusts §63, comment c (2003). Probate Code §15400 applies only to revocation by the settlor; the instrument itself may grant others, *e.g.,* beneficiaries, the power to revoke or terminate the trust.

Sometimes a settlor will precipitately revoke a trust out of a failure to understand its estate planning purposes. If there is concern about a possible misunderstanding, the trustee and his or her attorney may wish to discuss the reasons for revocation with the settlor and settlor's attorney. Together they can evaluate whether a trust modification, however substantial, is more appropriate to the settlor's intentions. Note that the trustee, particularly if he or she is paid to act or is a beneficiary, may be in a conflict-of-interest position in giving the settlor any advice. The trustee must also determine that the settlor has the capacity to revoke the trust; the settlor must have the same capacity to revoke a trust that is needed to execute a trust instrument.

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B. Revocation Procedure

§16.23 1. Procedure in Trust Instrument

If the instrument provides a method of revocation and explicitly makes that method exclusive, that method must be followed. If the instrument provides no method or does not make the provided method exclusive, revocation can be accomplished by a writing other than a will signed by the settlor and delivered to the trustee during the settlor's lifetime. Prob C §15401. See discussion in §§16.24-16.26.

PRACTICE TIP: If the settlors of a trust are a married couple or registered domestic partners and the trust holds community property, either settlor acting alone can revoke the trust as to community property, unless the trust expressly provides otherwise. The revoked assets will be distributed from the trust as community property. See Prob C §15401(b); Fam C §§297.5, 761(b). See further discussion in §16.25.

NOTE: Unless the court orders otherwise for good cause, for certain "trusts funded by court order"—*i.e.,* trusts that will receive funds under Prob C §2580 (substituted judgment), §3100 (particular transactions involving a disabled spouse or registered domestic partner), or §3600 (settlements or judgments for minors or incompetent persons)—the trust instruments must prohibit revocation without court approval. Cal Rules of Ct 7.903(a)(1), (c)(2).

Under prior law, which applies to revocable trusts created by an instrument executed before July 1, 1987, the procedure set out in the trust instrument had to be followed in revoking the trust if the procedure was explicitly exclusive or if the provision was so specific and detailed that it implicitly precluded any other method. See former CC §2258. If the trust provision was neither, then former CC §2280 (discussed in §16.26) allowed modification by delivering a signed modification to the trustee even if the trustee did not sign the amendment. See *Huscher v Wells Fargo Bank* (2004) 121 CA4th 956, 961, 18 CR3d 27, discussing former CC §2280 and cases interpreting that section, including *Hibernia Bank v Wells Fargo Bank* (1977) 66 CA3d 399, 136 CR 60; *Rosenauer v Title Ins. & Trust Co.* (1973) 30 CA3d 300, 106 CR 321. See also *Heaps v Heaps* (2004) 124 CA4th 286, 291, 21 CR3d 239 (trust not revoked as to community property residence that was transmuted into deed of trust held in joint tenancy when trust permitted trustee to hold asset in trustee's own name). Trusts created before 1931 that are silent about revocation are irrevocable under prior law. See former CC §2280. In *Masry v Masry* (2008) 166 CA4th 738, 82 CR3d 915, the court held that a husband's unilateral revocation of a joint revocable trust was valid even though notice was not given to his wife until after his death. The trust document did not state that the revocation method described in that document was the exclusive revocation method and the court held that the husband's actions satisfied the requirements of Prob C §15401(a)(2). See §16.25. In some cases, the trust instrument may preclude revocation by either settlor with respect to that settlor's share of trust property. In *Aguilar v Aguilar* (2008) 168 CA4th 35, 85 CR3d 193, the court held that a surviving spouse could not remove a share of a residence from a joint settled trust that expressly provided that the trust became irrevocable on the death of the first spouse to die and that also prohibited invasion of principal. In *Rands v Rands* (2009) 178 CA4th 907, 100 CR3d 632, the court held that a settlor lacked capacity to revoke his revocable trust when two physicians had previously determined that the settlor lacked capacity to manage his personal and financial affairs. An unusual trust clause provided that incapacity thus determined continued until a court determined otherwise, and the court held that a subsequent determination by two other physicians that the settlor had capacity did not overcome the initial determination of incapacity because the new physicians were unaware of the prior determinations.

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§16.24 2. Procedure if Trust Instrument Is Silent

If the instrument is silent about revocation but not specifically irrevocable, Prob C §15401 or former CC §2280 will control. All that is required to revoke the trust is a writing delivered to (under former §2280, "filed with") the trustee. This writing can be a simple statement, *e.g.,* "I, John Jones, settlor of the John Jones Revocable Trust, established on January 1, 2001, hereby revoke the trust in its entirety. Please deliver the assets to me as soon as possible."

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§16.25 a. Trusts Executed on or After July 1, 1987

Probate Code §15401(a)(2) provides that a trust that is revocable by the settlor may be revoked in whole or in part by either of the following methods:

- By compliance with any method of revocation provided in the trust instrument; or
- By a writing (other than a will) signed by the settlor and delivered to the trustee during the settlor's lifetime.

In *Gardenhire v Superior Court* (2005) 127 CA4th 882, 888, 26 CR3d 143, the court held that Prob C §15401(a)(2) notwithstanding, when the settlor's trust instrument required revocation by written notice without otherwise qualifying the term "written notice," the settlor's execution of a subsequent will had the effect of revoking her revocable trust. The court concluded that neither Prob C §15401(a)(1) nor (a)(2) required the settlor to expressly authorize revocation by will. Note that Prob C §15401(a)(2) was based in part on a portion of Restatement (Second) of Trusts §330, Comment j (1959), which is not included in the parallel discussion in Restatement (Third) of Trusts §63, Comments h and i (2003).

Unless the instrument specifically provides otherwise, if the settlors of a trust are a married couple, and the trust holds community property, generally either settlor acting alone can revoke the trust as to the community property. Fam C §761(b). See also Prob C §15401(b), which states that unless otherwise provided in the instrument, if a trust is created by more than one settlor, each settlor may revoke the trust as to the portion of the trust contributed by that settlor, except as provided in Fam C §761. One spouse acting alone cannot change community property held in a trust to separate property if the trust instrument provides that the trust is revocable as to that property during marriage and the power to modify the trust as to the rights and interests in that property during the marriage may be exercised only with the joinder or consent of both spouses. Fam C §761(a). See *Estate of Powell* (2000) 83 CA4th 1434, 1441, 100 CR2d 501 (community property interest of decedent spouse transferred to trust giving either spouse power to revoke during lifetime of *either* spouse was transmuted from community property to separate property on death of decedent spouse under Prob C §100; thus, surviving spouse's subsequent revocation was effective only as to his half of the trust corpus). Some trusts include a provision authorizing a married settlor acting alone to revoke only his or her community property interest in the trust property. Other trusts contain a more restrictive provision requiring both spouses to act together to revoke the trust as to community property.

If a trust is created by more than one settlor, and community property is not involved, each settlor may revoke the trust as to the portion of the trust assets contributed by that settlor unless the instrument provides otherwise. Prob C §15401(b).

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§16.26 b. Trusts Executed Before July 1, 1987

Under former CC §2280, there was no requirement that a revocation be filed with the trustee during the lifetime of the person revoking. Thus, a deathbed revocation delivered to the trustee after the settlor's death would probably be effective for trusts executed before July 1, 1987, if they were not amended after that date.

Probate Code §15401 does not apply to trust instruments executed before July 1, 1987. Prob C §15401(e). With respect to such trusts, one settlor of a multiple settlor trust may not have the right, acting alone, to revoke his or her share from the trust. A settlor's unilateral attempt to revoke his own share of a multiple-settlor trust was found invalid in *Estate of Wernicke* (1993) 16 CA4th 1069, 20 CR2d 481. The court held that one settlor could revoke that settlor's share only if the trust instrument specifically allowed such a revocation.

Case law under former CC §2280 held that any writing filed with the trustee that manifests the settlor's intent to revoke was sufficient as a revocation. *Fleishman v Blechman* (1957) 148 CA2d 88, 306 P2d 548 (serving trustee with quiet title complaint revoked trust). But if the settlor revokes the trust in a document with a separate legal purpose, the trustee's attorney should advise the settlor to execute a separate revocation to eliminate any later questions. But see *Rosenauer v Title Ins. & Trust Co.* (1973) 30 CA3d 300, 106 CR 321 (revocation by will not permitted if settlor reserves power to revoke in the trust by an inter vivos transaction).

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§16.27 3. Documenting Revocation of Trust

If the trust instrument provides that revocation must be in writing, the trustee's attorney should advise the trustee to obtain a signed and dated revocation from the person holding the power to revoke, generally the settlor, before taking any steps to terminate the trust, *e.g.,* changing title to assets. This precaution will prevent the trustee from incurring any liability, *e.g.,* costs of reregistering securities, if the person revoking changes his or her mind before signing the required writing. It will also protect the trustee from liability for improperly turning over the assets to the person revoking if that person dies without executing the revocation required by the trust instrument or by former CC §2280 or Prob C §15401(a)(2). Such liability could exist if the beneficiaries under the will (or by intestacy) and trust are not the same individuals. The heirs could claim the trust assets on the theory that the assets were held by or in the name of the decedent, while the trust beneficiaries might claim the assets as part of the trust. Even if the latter prevailed, the trustee would be liable for the costs of recovering the assets. See Prob C §§16420, 16440; *Estate of Talbot* (1956) 141 CA2d 309, 296 P2d 848 (trustee liable for good faith breach of trust must restore corpus and pay depreciation in value of corpus caused by breach, *i.e.,* interest from date of breach to date of restoration).

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C. Special Revocation Situations

§16.28 1. Revocation by Conservator of Estate

Probate Code §2580(b)(11) empowers the conservator of an estate, with the court's approval, to exercise a conservatee's right to revoke a trust. (See below for discussion of exceptions.) On revocation, the trust assets become part of the conservatorship estate. This provision is included in the substituted judgment sections of the Probate Code (Prob C §§2580-2586), which allow the conservator, with the court's approval, to do estate planning for the conservatee. See California Conservatorship Practice §18.4 (Cal CEB 2005).

The conservator or any other interested party may petition the court to allow the conservator to revoke a trust. Prob C §2580(a), (b)(11). The trustee, an interested party, and his or her attorney should consider filing a petition to revoke a trust in several situations. If the trust is too small to merit the costs of separate administration (particularly if the conservatee-beneficiary is depleting the assets), or if for other reasons unified management under a conservatorship would be more efficient, the trustee should consider petitioning under Prob C §2580(b)(11) to revoke the trust.

If the trustee is unable to work with the conservator, a petition for instructions might be more appropriate than termination, particularly when the remainder beneficiaries of the trust and the heirs of the prospective probate estate are apparently not the same, and the interests of the trust beneficiaries would be jeopardized by revocation of the trust.

The conservator cannot exercise the power to revoke if the trust specifically shows an intent that only the conservatee has the right to revoke, provides that the conservator does not have the right to revoke, or if the instrument otherwise shows an intent inconsistent with revocation by the conservator. Prob C §2580(b)(11). For an example, see Drafting California Revocable Trusts §20.7 (4th ed Cal CEB 2003). If the trust was created to provide special management of assets, *e.g.,* a closely held business or mineral interests, or if the beneficiaries of the trust are different from those under the will, revocation might be inconsistent with the settlor's intent.

If the trustee believes that any of the above exceptions exist, the trustee should not petition to authorize the conservator to revoke the trust, and should oppose any petition to revoke by the conservator. To do otherwise would be a breach of the trustee's fiduciary duty to carry out the trust's terms. Costs incurred in opposing improper revocation would be a charge against the trust. Prob C §15684(a); *Bixby v Hotchkis* (1943) 58 CA2d 445, 452, 136 P2d 597, 601 (trustee entitled to fees for defending trust). But see *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742 (attorney not entitled to fees in litigation challenging trust amendment because litigation was dispute between beneficiary of original trust and beneficiary under trust amendment rather than a challenge to existence of trust). See also *Terry v Conlan* (2005) 131 CA4th 1445, 33 CR3d 603 (trustee not entitled to use trust income to pay attorney fees incurred in asserting position of deceased settlor's children against surviving spouse in dispute over validity of competing trust documents).

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§16.29 2. Revocation by Agent Acting Under Power of Attorney

A trust may not be revoked by an agent under a power of attorney unless expressly permitted by the trust instrument and authorized in the power of attorney. Prob C §§4264(a), 15401(c). Further, in the absence of additional express authority, a court may conclude that express grants to take specified estate planning actions do not authorize making any changes in the beneficiaries or the interests they receive. For example, a court might conclude that authority to create a revocable trust authorizes creating the trust for the purpose of avoiding probate but does not authorize changing the eventual recipients of the principal's property. See, *e.g., Schubert v Reynolds* (2002) 95 CA4th 100, 115 CR2d 285. For pre-July 1, 1987, trusts, if an agent with apparent power to revoke is acting under a power of attorney for an incapacitated person, it is probably prudent for the trustee to petition the court for instructions on whether to accept the revocation unless the language in the durable power is absolutely clear. Even then, if the trustee believes that the durable power was obtained by fraud or duress or was executed after the settlor became incapacitated, the trustee and his or her attorney should consider petitioning the court for instructions, because a trustee, unlike other third parties to the power of attorney, generally has a fiduciary duty to protect the settlor and trust estate.

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3. Beneficiary's Right to Withdraw Principal Under "Five or Five" Power

§16.30 a. Notice of Withdrawal Right

Some trusts give the income beneficiaries a noncumulative right to withdraw annually the greater of 5 percent of the value of the principal or $5000. See IRC §2041(b)(2). For further discussion of "five or five" powers, see Drafting California Revocable Trusts §§7.90-7.92 (4th ed Cal CEB 2003). See also California Will Drafting §§16.17, 16.24 (3d ed Cal CEB 1992). These provisions are included in trusts to give the beneficiaries access to a portion of principal without giving them a general power of appointment, which would result in the entire trust being included in their estates. Note, however, that if a beneficiary exercises the power and receives distributed assets that are not subsequently consumed, the distributed assets will be included and taxed as a part of the beneficiary's estate.

Occasionally, a trust instrument will require a specific form of notice for the beneficiary to use when making the annual withdrawal. For Crummey trusts and other irrevocable trusts, the notice may be necessary to qualify contributions to the trust for the IRC §2503(b) gift tax annual exclusion. More often, the instrument is silent. If this is the case, the better course of action is for the beneficiary to send a letter advising the trustee of the beneficiary's decision to withdraw a portion of principal. In the letter, the beneficiary can also advise the trustee whether he or she desires the payment in cash or in assets of the trust.

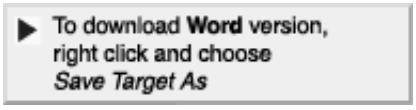
The beneficiary may not be aware of the right to withdraw principal. The language authorizing the power is often buried in the lengthy administrative provisions of the trust instrument and may easily be missed by someone unfamiliar with trust terminology. The trustee or the trustee's attorney should advise the beneficiary of the existence of a right to withdraw and explain its terms. Because the right is forfeited each year it is not exercised, the trustee may wish to ask the beneficiary at least annually whether the right will be exercised. This both shows the trustee's concern for the beneficiary and helps the trustee plan for future investment changes. If the beneficiary is planning to withdraw principal, the trustee should be advised to keep liquid assets available to satisfy the obligation.

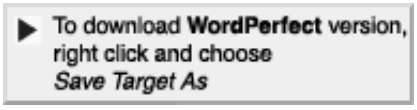
If the trustee begins to advise the beneficiary annually of the withdrawal right, the beneficiary may begin to rely on receiving the reminder. The trustee's attorney should caution the trustee, once the practice has begun, to send the letter each year, or the beneficiary may later try to hold the trustee liable if the letter is not sent and the right for a particular year lapses because the beneficiary forgot to make a request within the applicable time period. The letter to the beneficiary does not have to be complex. For a simple version, see §16.31.

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.31 b. Form: Letter to Beneficiary Regarding Exercise of Withdrawal Right

§16.31 b. Form: Letter to Beneficiary Regarding Exercise of Withdrawal Right





Dear _ _ _ _ _ _:

Once again it is time for my annual letter about your right of withdrawal from the trust. As you know, you have the right to withdraw $5000 or 5 percent of the trust's principal, which I estimate at this time to be approximately $_ _[*dollar amount*]_ _. In any year in which you do not exercise your right to withdraw the funds, your right to them is lost.

As in previous years, I would appreciate your indicating on the enclosed copy of this letter whether you wish to exercise your right of withdrawal for the year _ _[*year*]_ _.

If you have any questions concerning this, please call me.

Sincerely yours,
__[*Signature of trustee*]**__**
Trustee

[*Add, on letter copy*]

I wish to exercise my right to withdraw $_ _[*dollar amount*]_ _.

Date: _ _ _ _ _ _ **__**[*Signature of beneficiary*]**__**

I do *not* wish to exercise my right of withdrawal.

Date: _ _ _ _ _ _ **__**[*Signature of beneficiary*]**__**

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c. Timing of Withdrawal Right

§16.32 (1) Determining Year of Exercise

Trust instruments typically give the beneficiary the right to exercise the withdrawal privilege during each year or 12-month period. The instruments do not normally indicate to the trustee the beginning date of the first annual period. The period probably begins to run when the right is first available to the beneficiary: either the date establishing a testamentary trust or the date on which the beneficiary of a living trust first has the power to make the election.

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§16.33 (2) Valuation Date

Trust instruments will occasionally advise the trustee of the date to be used to value the trust for purposes of determining the 5 percent, *e.g.,* the last day of the calendar year or the anniversary date of the trust's creation. More often, there is no specified date. The trustee should select a logical date—perhaps the end of the first 12-month period—for the first-year period and use that same date thereafter. If the trustee arbitrarily selects different valuation dates each period, market fluctuations may cause substantially different results than if the assets were valued at the same time during each 12-month period. The beneficiary could elect to take any time during the period, and be paid "on account," with the final figure being determined after the anniversary date has passed. For tax purposes, the valuation of the property, to determine whether a lapse occurred, takes place on the date the lapse occurs. IRC §2041(b)(2).

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§16.34 (3) Determining Amount Subject to Election

A trust may be funded over a period of time, as often happens with a testamentary trust funded by a series of preliminary distributions. The right of the beneficiary to make the five or five election begins at the time of the first funding of the trust. However, if the trust is only nominally funded during the first year, with substantial distributions to follow, it is unclear whether the beneficiary's election applies to the actual amount in the trust during the first year or to the entire prospective principal. Absent language defining this in the instrument, an argument can be made that the right applies to the entire prospective principal available after total funding of the trust.

If the trust is not totally funded because of the needs of estate administration but will be funded at a future time, the right of the beneficiary to withdraw from principal should, in the author's opinion, extend to those funds. If the situation arises, the trustee should petition for instructions under Prob C §17200 to protect against later charges of misinterpretation and to notify all interested parties of what has happened.

Although the trustee has an ultimate right to receive these assets, the exact value of the right cannot be determined until the probate is completed. There will be fees, taxes, and other expenses that will not be completely fixed until after the decree of final distribution has been entered and all tax liabilities have expired. Accordingly, a close approximation of the total amount subject to five or five election is the best that can be done. To avoid possible overpayments (which would violate the five or five provision), the trustee should be conservative in making the approximations.

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§16.35 (4) Method of Payment

Absent trust provisions to the contrary, it appears that the beneficiary should be able to request the five or five payment either in cash or in trust assets. It will be easier for the trustee to pay smaller sums in cash, but in large trusts in which 5 percent may be substantial, the beneficiary may prefer to receive assets. For discussion of the tax effects to the trust and to the beneficiary of distributions in kind and distributions in cash, see chap 11.

The trustee and beneficiary may disagree on which assets will be used to satisfy the five or five power. In addition, the trustee should be mindful of the conflict that may exist between the current and remainder beneficiaries in terms of which assets are being distributed in satisfaction of the withdrawal right. The final decision is the trustee's responsibility, although the parties can usually resolve their differences. If necessary, the trustee can petition the court for instructions to determine which assets should be used to satisfy the withdrawal if it is thought that this approach would be more palatable to the beneficiaries.

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III. TERMINATION OF TRUST

§16.36 A. Termination on Occurrence of Specific Event

Usually trusts are terminated when an event stated in the instrument takes place. The event is typically the death of an individual, or the attainment of a specific age by one or all of the beneficiaries. Before acting, the trustee must be satisfied that the event has occurred. If death is the triggering event, the trustee should obtain a certified copy of the death certificate for each beneficiary. If the trust terminates on the beneficiary's attainment of a certain age, the trustee should obtain certified birth certificates for the beneficiaries unless the trust instrument states the date of birth for purposes of determining dates of termination.

If the trust is subject to continuing court supervision, the trustee should prepare a final accounting on termination of the trust, and his or her attorney should prepare a petition to settle the final account and to distribute the estate. The notice of report and account and petition for distribution will inform the beneficiaries that the trust has terminated. The trustee may also wish to send letters to the beneficiaries, informing them of termination. Preparation of the trustee's final accounting may take a substantial amount of time. The trustee may ask the beneficiaries to waive a final accounting if the beneficiaries have the necessary mental capacity. See chap 7 regarding reports and accounts.

A conservator can waive an accounting for a beneficiary who lacks capacity. If the beneficiary is a minor, a guardian or other person authorized to receive money belonging to the minor can waive the accounting on the minor's behalf. The waiver is analogous to that by guardians of minors for probate estates. Prob C §10954. By analogy with Prob C §10954(b)(6), a receiving trustee should not use a waiver of accounting when the trust terminates and assets are distributed to another trust if the receiving trustee represents unborn or unascertained beneficiaries. In some situations, the trustee will not file an accounting but instead will simply distribute the assets, balancing the time and cost saved against the risk that the beneficiaries will later challenge the trustee's actions. This often happens in family situations, when the trustee is related to the beneficiaries. The trustee may wish to seek written approval of these actions by the beneficiaries for his or her own protection. For further discussion of duties of the trustee on termination, see §§16.49-16.57.

It is good practice for the trustee or the trustee's attorney to write to the beneficiaries to notify them of termination of the trust, describing the steps that will be taken and providing a timetable for completion. See §16.54.

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B. Termination Because Trust Uneconomical to Administer

§16.37 1. Based on Provision in Trust Instrument

A trust provision may permit the trust to be terminated before the occurrence of the events specified in the instrument if the value of the corpus drops below a specific amount or is so low that the trustee believes the trust should be terminated.

The attorney advising the trustee who wishes to terminate the trust under such a clause or under the statutory provision for termination in Prob C §15408(b) (see §16.38) should ascertain that the value of the trust is low enough to comply with the requirements in the governing instrument. The attorney should advise the trustee to document the trust records in writing, stating why termination is in the beneficiaries' best interests.

Despite the clear language giving the trustee power to act without court approval, the trustee should nevertheless consider seeking instructions, particularly if there is any ambiguity or dissension among beneficiaries about distribution of the remaining assets. A trustee who does not wish to assume the risk of making the decision may petition the court for approval of the proposed plan of distribution.

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.38 2. Based on Statutory Provision

§16.38 2. Based on Statutory Provision

Absent a contrary provision in the trust, Prob C §15408 permits termination for low value on petition by the trustee. If the value drops to $20,000 or less, the trustee may terminate the trust without court approval. Prob C §15408(b).

In other cases, the court may order termination or modification of the trust if the court determines that the fair market value of the trust principal has become so low in relation to the cost of administration that continuation of the trust under its existing terms will defeat or substantially impair the accomplishment of its purposes. Prob C §15408(a). If the property is above the $20,000 threshold or above a corresponding threshold in the instrument but the trustee nevertheless deems the principal too low to administer, a petition will have to be filed. The court has discretion to act under Prob C §15408(a) and may decline to terminate or modify the trust even if all parties agree.

The existence of a trust provision restraining transfer of the beneficiary's interest does not prevent the termination or modification of the trust as provided in the statute. Prob C §15408(c).

PRACTICE TIP: "Cost of administration" is not defined in the statute. Often, the largest administration cost is the trustee's fee. Rather than terminate a trust in which fees are an undue burden, it may be appropriate to identify a family member who is willing to serve without compensation and to propose that the court appoint him or her as trustee. If costs other than fees are excessive, modification may be preferable to termination. For example, a trust holding a piece of unproductive property could, by its terms, require the trustee to pay annual inspection visits. If the cost of the trip is disproportionate to the value of the property, the trustee can petition the court to modify the trust to eliminate the annual inspection. Prob C §15408(a)(2).

PRACTICE TIP: Trusts holding assets of less than $500,000 are declined by many corporate trustees, and as existing trusts distribute assets, their decline in value may become precipitous. A trustee who no longer finds the trust commercially feasible may petition the court to terminate the trust, modify it (perhaps by accelerating payouts), or appoint a successor trustee, often a family member who is willing to administer it for less or no compensation.

The local court may have its own criteria for deciding whether to allow termination. In general, the decision will depend on the actual amount of the principal, the purpose of the trust, the type of assets, and the beneficiaries' ages. The court may not terminate a minor's trust but might agree, for example, to terminate a small trust when the beneficiary is 23 and demonstrably responsible in handling money rather than waiting until the beneficiary is 25 or 30. The court also may not terminate a trust for an elderly person who has difficulties handling financial matters, unless the assets can be turned over to an existing conservatorship or there is an agent acting under a durable power of attorney.

Petitions to terminate trusts not subject to continuing court supervision should follow the procedure for Prob C §17200 petitions. Probate Code §16062(a) requires an accounting on termination of a trust, although the beneficiaries may waive the accounting.

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§16.39 3. Distribution of Assets on Termination

If the court orders a trust terminated, the order must state how the property is to be distributed among the income and remainder beneficiaries. Except as otherwise directed in the trust instrument or agreement, Prob C §15410(c) provides that distribution must be in a manner that conforms as nearly as possible to the settlor's intent as expressed in the trust instrument. The trustee's attorney should assist the trustee in preparing a recommendation for the court's approval.

One possibility is to purchase an annuity for the income beneficiary for the amount to which he or she is entitled under the agreement, if it is a specific amount, or an amount equal to the sum of amounts commonly distributed to him or her, and distribute the remaining assets to the remainder beneficiaries. A second possibility is to distribute the present value of their income interests to the income beneficiaries and distribute the remaining assets to the remainder beneficiaries, based on income and remainder amounts calculated under Internal Revenue Code tables. See Temp Treas Reg §1.664-4T(e), which includes tables showing the present worth of a life estate and a remainder interest under interest rate assumptions from 4.2 to 14 percent. If the income beneficiary takes the assets at a certain age and the trust is being terminated before that date, another possibility is to distribute all the assets to this beneficiary, particularly when the contingent beneficiaries are not remote or unascertainable, *e.g.,* the beneficiary's issue.

If a trust is terminated under Prob C §15408 (termination for low value), the trust property may be distributed as determined by the trustee in a manner that conforms as nearly as possible to the settlor's intentions, as expressed in the trust instrument, without the need for a court order. When the trust instrument does not provide a manner of distribution at termination and the settlor's intent is not adequately expressed in the trust instrument, the trustee may distribute the trust property to the living beneficiaries on an actuarial basis. Prob C §15410(d).

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§16.40 4. Form: Petition to Terminate Trust Uneconomical to Administer Under Prob C §15408

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

Trust Created Under the Will of _ _[*name*]_ _, Deceased	**Case No. _ _ _ _ _ _**
[*Or*]	**PETITION TO TERMINATE TRUST (PROB C §15408)**
Trust Created by Agreement dated _ _[*date*]_ _, by _ _[*name of settlor*]_ _	**Hearing Date: _ _[*date*]_ _** **Time: _ _[*time*]_ _** **Dep't: _ _[*number*]_ _** **Judge: _ _[*if known*]_ _**

Petitioner, _ _[*name*]_ _, as Trustee of the above-titled Trust, hereby petitions the Court to terminate the Trust, and represents:

[*Add one of the following alternatives*]

[*Alternative 1*]

1. Petitioner became Trustee of the above-titled Trust by order of the Court dated _ _[*date*]_ _.

[*Alternative 2*]

1. Petitioner was appointed Trustee of the above-titled Trust by Trust Agreement dated _ _[*date*]_ _.

[*Continue*]

2. The Trustee has invested and reinvested the trust corpus in accordance with Article _ _ _ of the Trust pertaining to the investment of trust assets. There is property on hand in the trust estate as of _ _[*date*]_ _ as follows:

[*Insert description and value of trust assets*]

3. Article _ _ _ of the Trust requires the Trustee to pay the net income of the trust to _ _[*name of income beneficiary*]_ _ during _ _[*his/her*]_ _ life, and on _ _[*his/her*]_ _ death, to distribute the remainder of the trust to _ _[*name of remainder beneficiary*]_ _. In addition, the Trustee is empowered to invade trust principal for _ _[*specify purposes*]_ _ for the benefit of _ _[*name*]_ _.

4. The fair market value of the assets held in the trust was $_ _[*dollar amount*]_ _ as of _ _[*date*]_ _. The trust assets generated income of $_ _[*dollar amount*]_ _ during the _ _[*year*]_ _ calendar year. The costs incurred in administration of the trust for the same calendar year were $_ _[*dollar amount*]_ _, charged _ _ percent to income and _ _ percent to principal. Costs charged to income represent approximately _ _ percent of the trust income for the _ _[*year*]_ _ calendar year. Costs incurred in prior years were comparable in amount. It is estimated that administration costs charged to income will continue to be at least _ _ percent of the trust income.

5. Because the fair market value of the trust is low in relation to the cost of its administration, continuation of the trust under its existing terms will substantially impair the accomplishment of the purposes of the trust. It is in the best interests of the trust and the beneficiaries that the trust be terminated and that the assets be distributed to the beneficiaries of the trust as set forth below. The Trustee believes this to be the manner that conforms as closely as possible to the intent of the Settlor and is in the best interests of the beneficiaries:

[*Insert scheme of distribution and basis of scheme, e.g., annuity, tax table*]

6. The names and addresses of the beneficiaries of the trust estate are as follows:

Name	Address
_____	_____
_____	_____
_____	_____

[*Optional*]

7. The consents of the beneficiaries of the trust to its termination are attached as Exhibit _ _.

[*Continue*]

[8.] No request for special notice has been filed in this proceeding.

WHEREFORE, PETITIONER REQUESTS that:

1. The Court terminate the above-titled Trust;

2. All the acts of Petitioner as Trustee be confirmed and approved;

3. The Court order distribution of the trust assets, after payment of closing expenses, including attorney fees and trustee fees, to the trust beneficiaries in the following shares:

Name	Share
_____	_____
_____	_____
_____	_____

4. The Court discharge trustee on distribution of the assets of the trust to the beneficiaries as stated above;

5. All other proper orders.

Date: _ _ _ _ _ _ **By:**
__[*Signature*]__
Trustee

[*Verification; see §7.116*]

Comment: This form can be used with minor changes for termination of court-supervised trusts. However, an accounting will be required unless it is waived. See §16.41. For unsupervised trusts, it is the author's opinion that court approval of trustee and attorney fees is unnecessary. There is some difference of opinion, however, and local practice may differ.

Although consent of all beneficiaries is not required by statute, obtaining such consent will allow for a smoother termination. Courts are often reluctant to grant termination of a trust if the trustee cannot demonstrate that the beneficiaries agree.

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.41 5. Form: Consent to Terminate (and Waiver of Accounting) by Beneficiary

§16.41 5. Form: Consent to Terminate (and Waiver of Accounting) by Beneficiary

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_ _[*Caption; see §16.40*]_ _ **Case No.** _ _ _ _ _ _

CONSENT TO TERMINATE
_ _[*AND WAIVER OF ACCOUNTING*]_ _

I, _ _[*name of beneficiary*]_ _**,** _ _[*an income/a remainder*]_ _ **beneficiary of the Trust created by the agreement between** _ _[*name of settlor*]_ _ **as Settlor and** _ _[*name of trustee*]_ _ **as Trustee, dated** _ _[*date*]_ _**, hereby consent to the termination of the Trust and to the distribution of the trust assets in accordance with the petition to which this consent is attached. I waive my right to an accounting by the Trustee.**

Date: _ _ _ _ _ _ __[*Signature of beneficiary*]__
Beneficiary

Comment: The consent to terminate is not required for a Prob C §15408 termination.

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§16.42 6. Form: Order Terminating Trust Under Prob C §15408

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_ _[*Caption; see §16.40*]_ _ **Case No. _ _ _ _ _ _**

ORDER TERMINATING TRUST
(PROB C §15408)

The petition of _ _[*name of trustee*]_ _ as Trustee of the above-titled Trust, for an order of this Court terminating the Trust under California Probate Code §15408 _ _[*and for approval of attorneys' fees*]_ _ was duly presented to this Court.

On proof made to the satisfaction of the Court, the Court finds the allegations in the petition are true;

That, because the fair market value of the trust is low in relation to the cost of its administration, continuation of the Trust under its existing terms will substantially impair the accomplishment of the purposes of the Trust;

_ _[*That all beneficiaries of the Trust have consented to the termination of the Trust and to the petition to terminate the Trust presented to this Court*]_ _**;**

That all proper notices of hearing have been given as required by law, and, good cause appearing, grants the petition as follows:

IT IS ORDERED that:

1. The Trust Agreement between _ _[*name of settlor*]_ _, as Settlor, and _ _[*name of trustee*]_ _, as Trustee, dated _ _[*date*]_ _, is terminated.

2. _ _[*Name*]_ _, as Trustee, is authorized and directed to distribute the remaining assets on hand in the trust, after the payment of attorneys' fees, trustees' fees, and any costs of termination, as follows:

[*Insert distribution schedule*]

3. _ _[*Name*]_ _ is discharged as Trustee of the Trust on distribution of the assets as set forth above.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

Comment: The consent of all beneficiaries is not required for a Prob C §15408 termination.

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§16.43 C. Impossible or Illegal Purpose

If the purpose of the trust is either illegal or impossible to fulfill, the trust terminates. Prob C §15407. See 15 Ops Cal Atty Gen 250 (1950). Although the statute does not appear to require a court determination, to avoid potential liability the trustee should probably seek instructions from the court and court confirmation that the trust purpose is illegal or impossible to accomplish. When a trust is terminated for these reasons, the trust assets revert to the settlor or settlor's estate or to the testator's estate, unless there is an alternative disposition in the trust instrument, *e.g.,* to charity. See *Mallon v City of Long Beach* (1955) 44 C2d 199, 282 P2d 481. If the settlor is deceased and the probate estate is closed, the trustee's attorney should advise the trustee to check the decree of final distribution of the probate estate to see if it contains an omnibus clause disposing of after-discovered property other than to the trust. See 2 California Decedent Estate Practice §19.77 (Cal CEB 1986). If not, the trustee may have to reopen the probate or, if there was no probate, petition for letters. *Estate of Bouche* (1937) 24 CA2d 86, 74 P2d 563. Assets may also be distributed under Prob C §§13000-13660 if they apply. In trusts for charitable purposes, the trustee's attorney should consider whether the cy pres doctrine applies. See §16.18; *Society of Cal. Pioneers v McElroy* (1944) 63 CA2d 332, 146 P2d 962.

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.44 D. Consent of All Beneficiaries

§16.44 D. Consent of All Beneficiaries

Under Prob C §15403, if all beneficiaries consent, they may "compel" modification or termination of an irrevocable trust on petition, with two exceptions:

- If "continuance of the trust is necessary to carry out a material purpose of the trust" and the reason for modifying or terminating does not, in the court's discretion, under the circumstances, outweigh the purpose.
- If there is a "valid restraint on transfer of the beneficiary's interest," termination is not permitted.

For discussion of procedure and issues involved in obtaining consent of beneficiaries who lack legal capacity, are unborn, or unascertained, see §16.12.

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§16.45 E. Consent of Settlor and All Beneficiaries

If the settlor and all beneficiaries consent, they may "compel" termination of a trust. Prob C §15404(a). This is the case even if a material purpose of the trust cannot be carried out, or the reasons for modifying or terminating are less important, and even if there is a spendthrift clause protecting one of the beneficiaries. 20 Cal L Rev'n Comm'n Reports 1877 (1990). Procedurally, assuming that no one objects, there is nothing to bring before a court. If someone objects or the trustee wants an order for protection, the procedure to follow under Prob C §15404(a) is a petition under Prob C §17200(b)(13).

For discussion of obtaining consent of all beneficiaries, see §16.12.

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§16.46 F. Consent of Settlor and at Least One Beneficiary

Fewer than all beneficiaries, with the settlor's consent, can compel modification or partial termination of the trust on petition to the court if the interests of the nonconsenting beneficiaries are "not substantially impaired." Prob C §15404(b). Probate Code §15404(c) provides that, if a disposition of principal is to a group of persons who would take under the rules of intestate succession, the court may limit the class whose consent is needed to beneficiaries who are likely to take.

The procedure is a petition under Prob C §17200(b)(13). The issues to be decided are whether the settlor and at least one beneficiary have consented, and whether the interests of the nonconsenting beneficiaries are "not substantially impaired."

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§16.47 G. Changed Circumstances

The court may modify either administrative or dispositive provisions or terminate the trust "if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust." Prob C §15409(a). The statute further provides that, if necessary to carry out the purposes of the trust, the court may order the trustee "to do acts that are not authorized or are forbidden by the trust instrument." Prob C §15409(a).

The court must consider a trust provision restraining transfer of the beneficiary's interest as a factor in making its decision on whether to modify or terminate the trust, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer. Prob C §15409(b). In *Balian v Balian* (Dec. 11, 2009, B214434) 2009 Cal App Lexis 1978, the court held that a beneficiary of a special needs trust could petition to remove the monthly distribution limitation with respect to her interest in the trust under Prob C §15409 on the ground that the settlor had imposed the limitation only to preserve her eligibility for need-based public benefits when in fact the beneficiary received social security disability insurance benefits that were not based on financial need.

Procedure under Prob C §15409 is presumably a petition by the trustee or a beneficiary under Prob C §17200(b)(13). The issues appear to be:

- What are the purposes of the trust?
- Would the continuation of the trust under its terms defeat or substantially impair their accomplishment?
- If so, is it because of circumstances not known or not anticipated by the settlor?

The court may also terminate a trust with uneconomically low principal. See §§16.17, 16.37-16.38 for discussion.

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§16.48 H. Settlor as Sole Beneficiary

The settlor of an irrevocable trust who is also the sole beneficiary can terminate the trust if he or she has sufficient capacity to act. See Reporter's Notes for Restatement (Third) of Trusts §65 (2003). See also 5 Scott & Ascher on Trusts §34.3 (5th ed 2008). The rationale is that, because no one except the settlor has a beneficial interest in the trust, he or she should be able to do with it as he or she pleases. The required mental capacity to terminate an irrevocable trust by the sole beneficiary is the capacity necessary to execute, amend, or revoke the trust instrument.

It is often difficult to determine whether the settlor is the sole beneficiary. If the trust principal passes to the settlor's estate or personal representative, the settlor will be considered the sole beneficiary. Restatement (Third) §65. However, if the trust principal passes to an ascertainable third party or the settlor's "heirs," "children," or "issue," the settlor will not be considered the sole beneficiary; instead, an equitable interest will be created in the settlor's children, issue, or descendants, whether or not presently in existence. See Restatement (Third) §§49, 65; *Gray v Union Trust Co.* (1915) 171 C 637, 154 P 306; *Levy v Crocker-Citizens Nat'l Bank* (1971) 14 CA3d 102, 94 CR 1; *Bixby v Hotchkis* (1943) 58 CA2d 445, 136 P2d 597. But see *Bixby v California Trust Co.* (1949) 33 C2d 495, 202 P2d 1018, which reached a contrary result, based on the "doctrine of worthier title" (no longer applicable because that doctrine has been abolished; Prob C §21108). A spendthrift clause will not defeat the settlor's ability to terminate the trust if he or she is the sole beneficiary. *Bixby v California Trust Co., supra*.

If the settlor is deemed not to be the sole beneficiary because of a gift to an unborn class, Prob C §15405 provides a possible solution: A guardian ad litem "may rely on general family benefit accruing to living members of the beneficiary's family as a basis for approving … termination."

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IV. DUTIES OF TRUSTEE ON TERMINATION

§16.49 A. Fiduciary Responsibilities

The trustee is not immediately relieved of the responsibility to administer trust assets even though the process of distribution has begun. The trustee's duties and powers continue until all the affairs of the trust are completed. Prob C §15407(b). *Botsford v Haskins* (1978) 81 CA3d 780, 146 CR 752; Restatement (Third) of Trusts §89 (2007). For example, the trustee must continue to review trust investments. Before taking any necessary special action, *e.g.,* responding to a tender offer, the trustee should seek the beneficiaries' approval because the assets legally belong to the beneficiaries. If the beneficiaries are unavailable or fail to respond, the trustee should petition the court for instructions or, if time is of the essence, act using his or her best judgment, documenting efforts to contact the beneficiaries and justification for the action taken. The trustee should continue to manage real property and to insure and care for personal property. The trustee should buy or sell assets only to facilitate termination, not to increase value. Restatement §89, comment d.

The trustee has a duty to terminate the trust within a reasonable time. The Restatement speaks of such factors as the type of assets, whether the assets must be sold, the difficulty of ascertaining the beneficiaries, and whether there is any ongoing litigation. See, *e.g.,* Restatement §89, comment a. For example, if a trust contains a piece of real property with an ongoing quiet title action, the trustee may continue to hold the property until the litigation is settled; if the amount of time anticipated is substantial, however, the trustee's attorney should consider petitioning the court for specific authority to do so under Prob C §17200. If the beneficiaries believe that the trustee is taking an unreasonable amount of time, their remedies would be as follows:

- If the trustee is making distribution under an order authorizing and directing termination, petition the court to issue an order to show cause why the order is not being complied with.
- If the trustee is making distribution because a terminating event has occurred (*e.g.,* a death, reaching a certain age), petition the court under Prob C §17200(b) to order the trustee to distribute the assets to them, by a date certain if additional protection is needed.

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B. Administrative Duties

§16.50 1. Identifying and Locating Beneficiaries

On termination or revocation of the trust, the trustee must determine to whom the trust assets should be distributed. The trustee's records should include the names and addresses of the beneficiaries who are expected to take. Another source for the information in a court-supervised trust is the record of notices of court hearings. The trustee should check with members of the beneficiaries' families to make certain that no births or deaths have occurred that would alter the proposed plan of distribution. Good practice requires the trustee to make diligent efforts to ascertain whether major events, *e.g.,* births or deaths, have occurred.

Trusts that give the lifetime beneficiary a power of appointment over the trust's assets present special considerations in identifying the beneficiaries. The language in the trust instrument bestowing the power of appointment must be reviewed to see what is required. If the language requires that the power be exercised in the beneficiary's "valid last will" or "will duly admitted to probate" (or similar words), the trustee cannot distribute assets to those persons appointed in the beneficiary's will until the will has been admitted to probate and the period to contest the will has expired. This is true even if a probate is not otherwise required, because there is no other way to determine whether the will is in fact the beneficiary's last, valid will. The probate could then be terminated under Prob C §12251.

If the language bestowing the power of appointment does not require a "valid will" or will allow exercise of the power of appointment in any written instrument, the trustee may proceed to distribute the trust assets under the lifetime beneficiary's unprobated will or written instrument. Caution is advised, however, because the trustee who distributes without obtaining an order admitting the will to probate or seeking instructions regarding a written instrument takes the risk that a later will or instrument with different beneficiaries will be discovered or that the will in question will be declared invalid and the trust assets will go to the takers in default.

PRACTICE TIP: In some situations the trustee may be in doubt about who should take because of ambiguities in the document, unanticipated deaths, or similar circumstances. When the trustee is unsure of the identity of one or more beneficiaries, the trustee should petition the court for instructions under Prob C §17200(b)(4). See *Wells Fargo Bank v Marshall* (1993) 20 CA4th 447, 24 CR2d 507.

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§16.51 2. Distributions to Minors or Incompetent Adults

If a beneficiary is a minor or under an incapacity, the trustee should refer to the trust instrument for special instructions. Many trust instruments provide that distributions to beneficiaries who have not attained a specific age are to remain in trust until the age is reached, even though the trust would otherwise be terminated by some event. If there is no such language, the trust may provide that distributions can be made to the parent of a minor or to a custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925). Even without enabling language, the trustee may transfer the minor's property to a custodian under Prob C §3906(c) if all the following requirements are met:

- The trustee considers the transfer to be in the minor's best interest;
- The transfer to a custodian is not prohibited or inconsistent with the trust instrument; and
- The transfer is authorized by a court if it exceeds $10,000. Note, however, that court authorization is not required for a transfer exceeding $10,000 if the transfer is to a trust company or an individual named as a trustee under the trust instrument for whom bond is waived under the trust instrument. See also Prob C §16245.

Distribution can be made to the parent of a minor if the minor's total estate does not exceed $5000. Prob C §§3400-3402.

If the distributee is an adult for whom a conservator has been appointed, the trustee should distribute to the conservator unless the trust provides an alternative. Prob C §§1872, 2451, 16245. If the distributee has executed a durable power of attorney, the trustee can distribute to the beneficiary's agent if the powers granted to the agent allow administration of the property being distributed. If the trustee believes that a beneficiary who has not executed a durable power of attorney and has no conservator is incapacitated, it may be necessary to establish a conservatorship. If the question of incapacity is not clear, the trustee will have to determine whether to distribute to the person or to petition for appointment of a conservator. The decision should be based on the facts, including the nature of the assets to be distributed. For further discussion of conservatorships, see California Conservatorship Practice (Cal CEB 2005).

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§16.52 3. Determining Beneficiaries' Interests

Once the identities of the beneficiaries have been established, the trustee must determine what should be distributed to them. Occasionally, the trust will provide for gifts of particular assets, *e.g.,* shares of stock, tangible personal property, or real property. If the specified assets are not part of the trust, neither the trustee nor the trust is under a duty to distribute anything to these beneficiaries as long as the assets have not been disposed of contrary to the trust's terms, although the trustee should attempt to retain specifically mentioned assets if at all possible. See generally Restatement (Third) of Trusts §89 (2003). If the trust instrument requires retention and the trustee does not comply, the beneficiaries would have an action for breach of trust against the trustee.

After specific gifts are made, the trust instrument may provide that the remaining assets are to be distributed to certain beneficiaries or classes of beneficiaries in equal shares, or to certain classes of beneficiaries per capita or by right of representation. Probate Code §§245-247 establish rules of construction for trust dispositions to classes by right of representation or per capita.

The trustee should also determine who has rights to any accrued income in the trust. If the trust instrument is silent, income received by the trustee before the beneficiary's death is payable to the estate of the income beneficiary. Prob C §16345(d). Generally, the trust will provide that accrued income is payable to those next entitled to beneficial interests in the trust, the remainder beneficiaries in a termination. For discussion of such a provision in a QTIP trust, see California Will Drafting §§19.7-19.15, 19.21-19.31 (3d ed Cal CEB 1992). Even without such language, the trustee may have to make such a distribution in order not to jeopardize the marital deduction, in accordance with the testator's intent. For further discussion of accrued income, see chap 8.

PRACTICE TIP: While the interests of trust beneficiaries vest at the time the trust terminates, the trustee may be uncertain about the rights of the various beneficiaries to receive the trust assets on the date that the trustee is ready to distribute them, because this date might be months or even a year or more later. In that case, the trustee should seek court instructions. See *Salvation Army v Price* (1995) 36 CA4th 1619, 42 CR2d 925.

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§16.53 4. Notification of Beneficiaries

After the beneficiaries have been identified, the trustee should notify them that the trust has terminated. The trustee may wish to do so before working out a proposed plan of distribution, although in that case the trustee will have to again correspond with the beneficiaries to advise them of what they will receive. The trustee should also inform the beneficiaries of the approximate amount of time necessary to terminate the trust, as well as of any steps that must be taken, *e.g.,* an accounting to the court if under court supervision.

The trustee's attorney should determine whether the trust is subject to taxation on termination or if payment of any debts, taxes, or expenses must be made from the assets and whether a reserve will accordingly be required.

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§16.54 5. Form: Sample Letter to Beneficiary

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Dear _ _ _ _ _ _,

The _ _[*name*]_ _ Trust of which you are a beneficiary has terminated _ _[*state reason for termination*]_ _. Enclosed is a copy of the Trust Agreement for your information; the termination provisions begin on page _ _. I am now preparing to distribute the trust assets and would like to explain to you the steps I will be taking.

First, I will distribute any specific gifts to beneficiaries receiving them. Next, I will divide the remaining assets into equal shares as required by the trust instrument. You are entitled to receive _ _[*insert share or amount*]_ _. I will send you a proposed schedule of distribution for your review by _ _[*date*]_ _. I will distribute cash assets last because I want to make sure that there is sufficient cash to pay for the expenses of termination. At the end of the termination, I will send you a check to cover your share of the cash. The securities must be forwarded to transfer agents for reregistration in your name or wire-transferred to a brokerage account of your choosing.

Generally, transfer agents take _ _[*state amount of time*]_ _ to complete their work. The transfer agent will forward the securities to me and I will send them to you along with a receipt, which I will ask you to sign and return to me _ _[*, or the transfer agent will wire transfer the shares to your brokerage account and I will send you a receipt under separate cover*]_ _.

The receipt acknowledges that you have received the securities. Because transfer agents for different companies may take different amounts of time, you may receive the securities in several different batches.

I need from you as soon as possible your instructions regarding registration of the securities in your name or specific wire transfer instructions. I also will need you to complete _ _[*insert number, e.g. three; number of forms depends on number of institutions involved in transfer*]_ _ IRS _ _[*Form/s*]_ _ W-9 (Request for Taxpayer Identification Number and Certification). Please use the enclosed IRS _ _[*Form/s*]_ _ W-9 and the enclosed information sheet to provide me with this information and to confirm that your address is correct. A return envelope is provided for your convenience.

Any real property passing to you will also be listed on the schedule of distribution. I will have a new deed prepared and recorded and will then forward it to you _ _[*together with leases, insurance policy, etc.*]_ _, again, with a receipt, which I will ask you to sign and return to me. I will contact you shortly to discuss where you would like your share of the tangible personal property sent.

[*Add one of the following alternatives*]

[*Alternative 1: if there will be tax consequences of distribution]*

I will advise you of the income tax consequences of this distribution by way of a Schedule K-1 (Form 1041) and Schedule K-1 (Form 541) for federal and state tax purposes.

[*Alternative 2: if there will be no tax consequences of distribution]*

There are no federal or state income tax consequences resulting from this distribution.

[*Continue*]

If you have any questions, please do not hesitate to contact me.

Very truly yours,
__[*Signature*]__

Trustee

BENEFICIARY INFORMATION SHEET

Please have securities registered as follows:

Name:_____

Address of record:_____

OR

Please have securities wire transferred as follows:

Exact name on account:_____

Account number:_____

Name/address of brokerage company:_____
_____

Name of contact person at brokerage:_____

Exact wiring instructions:_____

Date: _ _ _ _ _ _ __[*Signature of beneficiary*]__

Comment: The trustee should enclose the beneficiary information sheet and the required number of IRS Forms W-9 with the letter to the beneficiary.

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§16.55 6. Methods of Distribution

A trustee may distribute assets either pro rata or otherwise. Prob C §16246. The author recommends that the trustee make prorata distributions except when all beneficiaries request a different scheme. A nonprorata distribution should be considered when spouses have agreed in writing, as permitted under Prob C §16246, to a nonprorata distribution of community property and quasi-community property. Prorata distribution will eliminate any later claims of favoritism and resulting claims of liability if some assets increase in value while others do not or lose value. In preparing the distribution, the trustee should use the value of the assets as of the trust's termination date, regardless of the amount of time needed to actually carry out the distribution. But see chap 14 for discussion of adjustments that may be necessary in marital trust formula funding.

Some assets, *e.g.,* a $1000 par value bond, cannot be split. The trustee will have to decide whether the asset should be distributed in kind to one beneficiary with a corresponding offset of other assets to another beneficiary, or sold with the proceeds split equally among the beneficiaries.

The trustee should deliver securities, especially negotiable bonds, by insured registered mail to ensure delivery to the correct person. Personal property creates difficulties. If the items are small, the trustee should ask the beneficiary to pick them up if he or she is in the area so that the trustee can obtain a receipt immediately. Otherwise, the trustee should arrange for shipping and should insure the shipment.

On distribution following a court ordered termination of trust, the trustee should obtain a receipt from each beneficiary for filing with the court. See §16.56 for sample form.

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Source: Estate Planning/California Trust Administration/16 Modification, Revocation, and Termination of Trust/§16.56 7. Form: Receipt on Distribution

§16.56 7. Form: Receipt on Distribution

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

[*Add one of the following alternatives*]

[*Alternative 1*]

Trust created under the Will of _ _[*name of decedent*]**_ _, dated _ _**[*date*]**_ _**

Case No. _ _ _ _ _ _

RECEIPT ON DISTRIBUTION

[*Alternative 2*]

In the matter of the
[*If applicable, add one or more of the following options*]

Case No. _ _ _ _ _ _

RECEIPT ON DISTRIBUTION

[*Option 1: Trust Agreement*]

Trust Agreement dated _ _[*date*]**_ _ between _ _**[*name of settlor*]**_ _ and _ _**[*name of trustee*]**_ _**

[*Option 2: Declaration of Trust*]

Declaration of Trust of _ _[*name of settlor*]**_ _, dated _ _**[*date*]**_ _**

[*Continue*]

_ _[*Name of beneficiary*]**_ _ hereby acknowledges receipt from _ _**[*name of trustee*]**_ _ as Trustee _ _**[*under the Trust of the above-named decedent/of the above-referenced _ _*[*1st option Trust Agreement/2d option Declaration of Trust*]*_ _*]*_ _ of the following property being distributed under decree, dated _ _*[*date*]*_ _:**

[*Describe property being distributed in detail, e.g., 100 shares of XYZ stock, $2000 cash*]

Date: _ _ _ _ _ _ __[*Signature of beneficiary*]__

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§16.57 8. Final Steps on Termination

After delivery of the assets, the trustee must file final federal and state fiduciary tax returns. The trustee should arrange for the storage of the trust records, because the beneficiaries may need or request the information at a later date, or the trustee may need the information if any actions are later challenged by a beneficiary. The trustee should keep these records for at least 3 years after all assets are distributed, which is the applicable statute of limitations for actions involving breach of trust other than fraud. Prob C §16460. However, the trustee may wish to keep certain records for a longer time or indefinitely.

In trusts subject to continuing court supervision, or in any distribution or termination approved by the court, the trustee's attorney should consider obtaining a court discharge for the trustee. It should either be part of the court order terminating the trust, in which case it would be effective on distribution of the assets, or it can be obtained after all the beneficiaries' receipts are filed with the court. Although this will end the trustee's personal liability for actions involving the trust corpus by third parties, if any further action is needed regarding trust assets, the trustee should petition the court for reappointment. There is no equivalent procedure to discharge a trustee of an unsupervised trust. See §16.58 for sample form.

PRACTICE TIP: Some counties have their own forms for Declaration of Final Discharge. The practitioner should check local rules.

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§16.58 9. Form: Declaration of Final Discharge; Order

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SUPERIOR COURT OF THE STATE OF CALIFORNIA,
COUNTY OF _ _ _ _ _ _

Trust created under the Will of _ _[*name of decedent*]**_ _, deceased**

Case No. _ _ _ _ _ _

DECLARATION OF FINAL DISCHARGE; ORDER

I, _ _[*name of trustee*]**_ _, declare that I am Trustee of the named Trust, and state that all sums of money due from me as Trustee have been paid and all property of the trust estate has been delivered to the parties entitled to it in accordance with the judgment and decree of distribution _ _**[*or order terminating Trust*]**_ _ made herein; that receipts of the distributees are on file herein; _ _**[*and*]**_ _ that all lawful acts of the Trustee have been performed _ _**[*; and that bond in the amount of $_ _*[*dollar amount*]**_ _ should be exonerated*]**_ _.**

I declare under penalty of perjury that the foregoing is true and correct and that this declaration was executed on _ _[*date*]**_ _, at _ _ _ _ _ _, California.**

Order of Final Discharge

It appearing from the above Declaration that the above-titled Trust has been fully administered and that a decree of discharge is proper,

It is therefore ordered that _ _[*name of trustee*]**_ _, as Trustee of the above-titled Trust, is hereby released and discharged from all liability to be hereafter incurred _ _**[*and that bond in the amount of $_ _ _ _ _ _ is exonerated*]**_ _.**

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

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17

Long-Term Trust Administration

James P. Lamping

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§17.1 I. CONTINUING TRUST ADMINISTRATION

This chapter analyzes the salient issues relating to a continuing trust administration with a noncorporate fiduciary acting as trustee. A continuing trust administration can present significant challenges for a noncorporate trustee. The process will often require the trustee to navigate thorny legal issues, work with a variety of professional advisors, and balance the demands of competing beneficiaries. On using a team approach, see §17.2. On using a checklist approach, see §17.3. Unless the attorney establishes a systematic approach to organize and define the administration, it can easily spin out of control. This is of particular concern when accepting a case in which the trustee was previously represented by other counsel.

In today's litigious environment, the keys to insulating the trustee from liability are organization, documentation, seeking court approval for the trustee's actions, and using notices of proposed actions. It is also very important for the trustee to establish and maintain a friendly relationship with each beneficiary. Fear of the unknown, hostile relationships, and lack of trust are often the catalysts for litigation that could otherwise be avoided. Managing the interpersonal aspects of trust administration is often just as important as tending to the technical legal requirements.

A long-term trust administration should be viewed as a process, rather than a single event. This involves constant monitoring, and the best practice is to be proactive in identifying potential problems before they come to fruition. By actively providing a formal structure to the trustee, the attorney can help to ensure that a long-term trust administration is conducted properly.

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§17.2 A. Team Approach

An ideal situation will involve a team approach by professional advisors, with certified public accountants (CPAs), investment advisors, and other professionals each bringing their unique skills to the decision-making process. The attorney's role is to organize and define the overall process. This process begins before the trustee ever meets with the attorney, when the attorney establishes the overall structure that will be used to diagnose and complete the required tasks. See §§17.4-17.11. On the initial meeting with the trustee, see §§17.12-17.44. On actions following the initial meeting with the trustee, see §§17.45-17.61. On trust maintenance, see §§17.62-17.65.

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§17.3 B. Checklist Approach

One of the keys to bringing organization to the long-term trust administration is the use of a checklist. The attorney can ensure that the administration is handled in an orderly and thorough manner, thus minimizing the trustee's exposure to liability, by using a checklist system throughout the life cycle of the trust administration to make sure that items are not overlooked. This checklist will form the organizational backbone of the administration. See §17.66. For a comprehensive procedural checklist for a single-settlor trust, see §13.2. For a comprehensive procedural checklist for a married settlor trust on the first death, see §14.110. Additional important documents are the trust beneficiary financial questionnaire (see §17.67), table of trustee duties (see §17.68), and team management chart (see §17.69).

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§17.4 II. ACTIONS PRIOR TO INITIAL MEETING

The process of providing organization and structure to the trust administration process begins before the attorney even meets with the client. The attorney should obtain and organize as much information as possible before the initial consultation with the client to ensure that the initial meeting is productive and the administration starts off on the right track. See §17.5. This will permit the attorney to go into the initial consultation with a game plan in place. However, the attorney first must identify the client (see §17.6) and check potential conflicts (see §17.7). In addition, the attorney should prepare a trust summary (see §17.8), review asset information and financial records (see §17.9), prepare documents to be signed at the initial meeting (see §17.10), and prepare a calendar of deadlines (see §17.11).

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§17.5 A. Begin Information Gathering Process

The information gathering process should start well before the initial consultation with the client. This process usually starts with an inventory of information in the attorney's file, often followed by a request for additional information from the client or other relevant professionals. This request should be in writing to avoid oversights and misunderstandings. See §13.84.

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§17.6 B. Identify the Client

Identifying the client is generally the starting point for any representation. See §1.10. Additional issues may arise if the attorney is contemplating the representation of cotrustees. See §1.16. On potential conflicts with the prospective client, see §17.7. On identifying the client at the initial meeting, see §17.13. On representing a single individual client in the dual capacities of trustee and beneficiary, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel 52 (State Bar of California 2008 ed).

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§17.7 C. Check Potential Conflicts

The attorney should perform a conflict check for all current and former trust fiduciaries. This is especially important in a long-term trust administration because it may become necessary for the current trustee to take the position that a former trustee is liable to the beneficiaries for some loss to the trust, or even to litigate against the former trustee. It should be noted that not all fiduciaries will be named in the trust instrument. For example, a court may have appointed a trustee upon a vacancy or on an interim basis during pending litigation. Some trust instruments also permit existing trustees to appoint successor trustees in the event of a vacancy. For these reasons, the prospective client should be asked for the names of all prior fiduciaries to identify fiduciaries not named in the trust instrument.

A conflict check should not necessarily be limited to current and former trustees. The scope of potential conflicts will normally be dictated by the precise terms of the trust and circumstances of the case. For example, a conflict check should be performed for the trust protector or any special trustees if those offices are created by the trust instrument. The names of beneficiaries should also be checked, as the future actions of the trustee may be adverse to them. Although the precise range of potential conflicts may vary from case to case, the scope of the conflict check may need to be broader than the attorney might initially contemplate.

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§17.8 D. Prepare Trust Summary

To avoid fumbling for details regarding the trust during the initial consultation and follow-up meetings, the attorney should prepare a trust summary for later reference. See §§13.4, 13.86. The trust summary should include any amendments that may have been made by the settlor's agent under a power of attorney. See §13.4A.

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§17.9 E. Review Asset Information and Financial Records

The prompt and accurate collection of asset information is one of the most important tasks in a trust administration. In order to have a productive initial consultation with the trustee, the attorney must have at least a basic understanding regarding the financial circumstances of the trust. After conducting a review of the relevant financial data, a spreadsheet should be created that will essentially serve as a balance sheet for the trust. See §13.89. This will assist the attorney in reviewing the finances of the trust with the trustee to identify issues that require attention, as well as to identify those items that are missing or require more information. For a sample letter requesting information from the settlor's accountant, see §14.13D.

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§17.10 F. Prepare Documents to Be Signed at Initial Meeting

The precise nature of the documents to be signed at the initial meeting with the client will often be dictated by what was prepared during the initial administration of the trust. At a minimum, an authorization to disclose information should be prepared for the client's signature. This will permit the attorney to communicate directly with financial institutions and other relevant parties regarding the finances of the trust.

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Source: Estate Planning/California Trust Administration/17 Long-Term Trust Administration/§17.11 G. Prepare Calendar of Deadlines (To Be Updated Continually)

§17.11 G. Prepare Calendar of Deadlines (To Be Updated Continually)

All deadlines and due dates should be entered on a calendar and updated continually. By preparing this calendar before the initial meeting, the attorney can direct the trustee's attention to the most urgent items.

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§17.12 III. INITIAL MEETING WITH TRUSTEE

Unlike a probate estate, a trust administration does not have court-imposed formalities. Therefore, the attorney must create the procedures necessary to implement a proper administration. The starting point will be to review the trust document and explain the duties imposed on the trustee under the Probate Code and case law. First, however, the attorney must identify the client and scope of representation to those present at the meeting. See §§17.13-17.15. Next, the attorney should identify issues that require immediate attention. See §§17.16-17.21. Then the attorney should review the trust document in detail with the trustee (see §17.22) with particular attention to standards for distributions (see §§17.23-17.29) and explain the trustee's duties under the instrument and relevant law (see §§17.30-17.43). Finally, the attorney should identify additional documents required and schedule a follow-up meeting. See §17.44.

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§17.13 A. Identify Client and Scope of Representation

The attorney should identify the client and the scope of the representation at the initial consultation. Beneficiaries sometimes wish to participate in the initial consultation, particularly when the trustee is a family member. This can be a delicate issue. One approach may be to meet first with the trustee alone. In many cases, the trustee may prefer to meet with the attorney alone but is uncomfortable expressing this preference in the presence of the beneficiaries. The trustee should be advised regarding the implications (particularly for the attorney-client privilege) if other persons are present. See §17.14. On the role of beneficiaries, see §17.15.

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§17.14 1. Articulate Identity and Capacity of Client

If any person other than the trustee is present at the initial consultation, the attorney should specifically articulate the identity of the client and any other persons present should be advised that they are not being represented. If the trustee is also a beneficiary of the trust, the attorney should specifically explain that the attorney represents the trustee in the capacity of trustee only and not as a beneficiary of the trust. The client should also be advised on how the presence of third parties affects the attorney-client privilege. While defining the attorney-client relationship from the outset is always important, it is especially critical when litigation may be imminent. For a discussion of the attorney-client relationship in the probate litigation context, see California Trust and Probate Litigation, chap 3 (Cal CEB 1999). Once these issues have been addressed, the attorney may discuss substantive issues with the trustee.

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§17.15 2. Discuss the Role of Beneficiaries in the Representation

The role of the beneficiaries should be clearly defined from the outset. It should be made clear during the initial consultation that the attorney represents the trustee in the role of trustee only, and not any particular beneficiary. Preferably, this arrangement should be confirmed in writing following the initial consultation.

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§17.16 B. Identify Issues Requiring Immediate Attention

In some cases, a particular issue such as pending or contemplated litigation may require immediate attention. Frequently these will be issues at the top of the trustee's agenda. It is often best to address such issues immediately after dealing with the preliminary ethical issues pertaining to the representation, as the trustee may feel distracted until these issues have been discussed. A nonexclusive list of common issues might include the following: actual or threatened litigation (see §17.17); tax issues (see §17.18); problems with the trust instrument (see §17.19); beneficiaries who need immediate distributions (see §17.20); and liquidity needs (see §17.21).

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§17.17 1. Actual or Threatened Litigation

Immediate attention is required when the trustee has already received a petition, or even when the threat of litigation is in the air. Separate files should be opened when the attorney intends to represent the trustee in both the litigation and the trust administration. This will permit the trustee to isolate those fees associated with each matter. In addition, the attorney-client privilege is narrower with respect to the trust administration, and keeping separate files will ensure that the privilege is protected to the extent possible. Indeed, it has been suggested that the trustee must retain separate counsel paid from personal funds to preserve the attorney-client privilege in *Moeller v Superior Court* (1997) 16 C4th 1124, 1134, 69 CR2d 317. See §9.40. Depending on the role of the attorney in the past affairs of the family, it may be necessary for the trustee to retain separate counsel for any litigation. See California Trust and Probate Litigation §3.1 (Cal CEB 1999).

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§17.18 2. Tax Issues

In most instances, the estate tax return will have been filed during the initial administration when one is required. See chap 12. However, income tax issues, audits, or other issues may arise many months later. See chap 11.

When an election has been made under IRC §6166 to pay the estate tax in installments, special attention should be paid to the date of the next installment to ensure adequate liquidity. It is also necessary to discuss the need to monitor the administration for continuing compliance when the trustee has made a special use valuation election under IRC §2032A. See §§13.36, 14.66.

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§17.19 3. Problems With the Trust Instrument

One of the primary reasons to conduct an extensive review of the trust instrument before the initial consultation with the trustee is to identify problem areas in the trust instrument. Issues may arise that are inherent in the document, such as ambiguously drafted provisions or other patent defects. Moreover, even a well-drafted document may present problems in actual application. In some cases, the attorney should consider modification of the trust to address these problems. See chap 16.

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§17.20 4. Beneficiaries Who Need Immediate Distributions

It is not unusual for a trustee to receive pressure from beneficiaries to make distributions as soon as possible. In many instances, this reflects a desire to obtain the immediate enjoyment of the trust assets. However, when there is an immediate need for distributions to pay for essentials of life, the trustee may wish to move forward with immediate distributions. See §17.23.

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§17.21 5. Liquidity Analysis and Budgeting

One reason to have asset information available at the initial meeting is to analyze the liquidity needs of the trust. Liquidity is especially important when it is anticipated that cash will be needed for mandatory distributions, the installment payment of estate taxes under IRC §6166, or payment of administration expenses. By being proactive from the outset, the trustee can anticipate future shortages of cash and take actions to avoid a fire sale of assets later. For an example of information used in performing a liquidity analysis, see §13.110.

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§17.22 C. Review Trust Instrument in Detail

The trustee should leave the initial consultation understanding, at least in general terms, the rights and duties assigned to him or her under the terms of the trust. The level of detail that can be covered during the initial consultation will depend on the client's capacity to absorb the information before reaching a saturation point. That said, certain areas warrant particular emphasis in almost every case. See discussion in §§13.23-13.24. In particular, the attorney should pay careful attention to the standards for distribution (see §§17.23-17.29) and duties imposed on trustees generally (see §§17.30-17.33), as well as the trustee's duties under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) (see §§17.34-17.41).

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§17.23 D. Discuss Standards for Distributions

Particular attention should be paid to the use of the words "shall" and "may" in distribution provisions. The word "shall" indicates that it is mandatory that the trustee take a particular action, whereas the word "may" implies that an action is within the trustee's discretion. When the trust instrument (*e.g.*, a QTIP trust) requires a mandatory distribution of income, the attorney should explain the concept of income to the trustee. See §17.24. On discretionary distribution provisions, see §17.25.

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§17.24 1. Mandatory Income Interest

The meaning of the word "income" in the trust context is one of the concepts most commonly misunderstood by nonprofessional fiduciaries. A trust provision requiring the distribution of all income (or net income) means that the trustee is to distribute all fiduciary accounting income. See chap 8.

NOTE: The concept of fiduciary accounting income is separate and distinct from the common understanding of income as taxable income. For example, capital gains are allocated entirely to principal for fiduciary accounting purposes, even though capital gains taxes are a form of income taxes. As a result, income beneficiaries would not be entitled to a distribution as the result of a capital gain, even though the trustee must report it on the trust's income tax return.

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§17.25 2. Discretionary Distribution Provisions

When the trust instrument grants discretionary distribution powers, the trustee should be advised to schedule meetings with beneficiaries at regular intervals and document the subjects discussed at these meetings in meeting minutes or confirming correspondence. It is also advisable for the trustee to maintain a journal documenting every communication or action taken in relation to the trust. The attorney should explain that the trustee's discretion is subject to an ascertainable standard (see §17.26) or a nonascertainable standard (see §17.27). On special types of discretionary trusts, see §17.28. On consideration of a beneficiary's other resources, see §17.29. For an excellent article regarding discretionary distribution standards that remains as relevant today as when it was written, see Halbach, *Problems of Discretion in Discretionary Trusts*, 61 Colum L Rev 1425 (1961).

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§17.26 a. Ascertainable Standard

The trustee should understand that the words "health, support, education and maintenance" are terms of art in the context of a trust administration. To a large degree, these terms originate from the application of tax laws to place limits on a beneficiary's right to use trust assets, as provided in a typical bypass trust to avoid inclusion in the surviving spouse's estate. See Treas Reg §20.2041-1(c)(2) (powers limited by an ascertainable standard):

> As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

In other instances, the Restatement of Trusts is useful to provide guidance regarding the meaning of distribution terms. For example, Restatement (Third) of Trusts §50, Comment d(3) (2003) provides definitions for the standards of "education" and "health," which may be expanded by the language of a particular trust:

> [T]he term "education," without elaboration, is ordinarily construed as extending to payment of living expenses as well as fees and other costs of attending an institution of higher education, or the beneficiary's pursuit of a program of trade or technical training, and the like, as may be reasonably suitable to the individual and to the trust funds available for the purpose.
>
> Similarly, without more, references to "health," "medical care," and the like in the terms of a discretionary power may be useful to inform beneficiary expectations or guide an inexperienced trustee, but presumptively they provide merely for health and medical benefits like those normally implied by a support standard. Thus, if the intention is to assure the beneficiary some special form of education, or expensive home care when not cost efficient, further elaboration would be helpful.

For a detailed discussion regarding the application of ascertainable standards, see §§2.66-2.76. See also Drafting California Revocable Trusts §§7.55-7.65 (4th ed Cal CEB 2003).

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§17.27 b. Nonascertainable Standard

The use of a nonascertainable standard may provide the trustee with broader authority over distribution. As stated by Restatement (Third) of Trusts §50, comment d(3) (2003) with respect to the nonascertainable standard of "happiness":

> The terms of a discretionary standard occasionally include stronger language, such as the word "happiness." Such language suggests an intention that the trustee's judgment be exercised generously and without relatively objective limitation. Although "happiness" alone expresses no objective minimum of entitlements (which to some extent may nevertheless be readily implied), the primary effect of such a term is to immunize from challenge by remainder beneficiaries almost any reasonably affordable distributions. This, however, does not mean that the trustee cannot properly resist any reasonable request by the beneficiary, because the decision remains one within the fiduciary discretion of the trustee.

As discussed in the above quoted text and below, even a broad grant of authority to a trustee does not confer unlimited powers, but rather is limited by the trustee's fiduciary duties. See §17.31. Subject to that limitation, a trust may allow the trustee to favor one class of beneficiaries over another. *Hearst v Ganzi* (2006) 145 CA4th 1195, 1208, 52 CR3d 473. See §2.44.

In addition, a trust may allow the trustee to distribute different amounts to beneficiaries of the same class. For example, a sprinkling provision may permit a trustee to distribute more to one child than another. This approach may be used when the settlor desired to provide for multiple beneficiaries, but was uncertain that the assets would be sufficient to provide for equal distributions. See Drafting California Revocable Trusts §7.81 (4th ed Cal CEB 2003).

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§17.28 c. Special Types of Discretionary Trusts

As discussed in §17.31, the discretion granted to a trustee under a trust instrument is not absolute. In deciding whether the trustee's discretionary actions are appropriate under the applicable distribution standard, a court will consider the settlor's intentions as expressed in the trust instrument. Prob C §21102. In certain types of trusts, it is common for the settlor's intentions to be expressly identified.

For example, the primary purpose of a special needs trust is normally to supplement the public benefits received by the beneficiary, and the distribution powers in a special needs trust must be discretionary in order to achieve this objective. See Special Needs Trusts: Planning, Drafting, and Administration, chap 14 (Cal CEB 2008); Drafting California Revocable Trusts §7.95 (4th ed Cal CEB 2003). In a similar vein, a trust created for a minor or incapacitated beneficiary will likely be entirely discretionary because mandatory distributions outright to the beneficiary could necessitate the initiation of a guardianship or conservatorship. See California Will Drafting, chap 22 (3d ed Cal CEB 1992) (testamentary trusts for minor children).

In these types of trusts, the primary intent of the settlor is often to provide for beneficiaries who may be unable to represent their own interests, and a court may very well view the reasonableness of a trustee's actions through that lens. By contrast, a court may be willing to give a trustee greater latitude in not making distributions when the trust was primarily intended to protect beneficiaries from themselves. For example, this may be the case when a settlor has created a trust for the express purpose of discouraging a beneficiary from continuing a pattern of substance abuse. See also Revocable Trusts §19.12; Will Drafting, chap 27 (spendthrift clauses). Whatever the specifics of the situation, discretionary powers will likely be interpreted within the context of the overall purpose of the trust as expressed by the settlor.

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§17.29 d. Consideration of Beneficiary's Other Resources

When the trustee is required (or even permitted) to consider the beneficiary's resources in deciding whether to make distributions, the trustee should request that the beneficiary complete a budget showing income and expenses. A form of budget is provided in §17.67. In addition, the trustee may request that the beneficiary complete IRS Form 4506, which will permit the trustee to obtain a copy of the beneficiary's tax return directly from the IRS. For further discussion regarding the consideration of the beneficiary's other resources, see §§2.72-2.76. See also Drafting California Revocable Trusts §§7.66-7.68 (4th ed Cal CEB 2003).

PRACTICE TIP: A budget provided by the beneficiary is a crucial tool in evaluating the need for discretionary distributions. In making discretionary distributions, the trustee should be aware of the expected future needs of the beneficiary. For example, smaller distributions may be appropriate when a special needs beneficiary has a long life expectancy. In contrast, large distributions may be appropriate to enable the beneficiary to become self-sufficient, *e.g.,* by attending medical school. The beneficiary's future needs also may affect the selection of an appropriate investment strategy.

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§17.30 E. Discuss Trustee's Duties Under the Instrument and Relevant Law

It is incumbent on the attorney to create the formalities in a trust administration that would be imposed by a court in a probate estate or a judicially supervised trust. See chap 15. The attorney should regularly review with the trustee the obligations imposed by the Probate Code and the trust instrument. To facilitate this process, it is often useful to provide the trustee with a table listing the duties of a trustee under the Probate Code, as provided in §17.68. For a table of trustee powers, see §2.53A. On the exercise of discretionary powers, see §17.31. On the duty to maintain records, see §17.32. On principal and income allocation, see §17.33. On prudent investing, see §§17.34-17.41. On accounting, see §17.42. On insurance, see §17.43.

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§17.31 1. Exercise of Discretionary Powers

Even when a trust provides a trustee with discretionary powers, the trustee still has an obligation to exercise those powers reasonably. Probate Code §16080 provides: "Except as provided in Section 16081, a discretionary power conferred upon a trustee is not left to the trustee's arbitrary discretion, but shall be exercised reasonably."

EXAMPLE: In *Penny v Wilson* (2004) 123 CA4th 596, 20 CR3d 212, the court held that a surviving spouse acting as trustee did not act reasonably in allocating properties between subtrusts, 16 years after the survivor's death, in such a manner that certain beneficiaries were deprived of the benefit of subsequent appreciation. See §2.43.

Even when a trust purports to grant a trustee entirely uncontrolled discretion, the Probate Code will generally preclude the trustee from acting in bad faith. Subject to certain qualifications, "if a trust instrument confers 'absolute,' 'sole,' or 'uncontrolled' discretion on a trustee, the trustee shall act in accordance with fiduciary principles and shall not act in bad faith or in disregard of the purposes of the trust." Prob C §16081(a). See *Penny v Wilson, supra*.

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§17.32 2. Duty to Maintain Records

The trustee should be advised of the duty to maintain adequate records. Although this is generally thought of in terms of financial records, it often covers much more. For example, in the case of a discretionary trust (such as a special needs trust or family pot trust), the trustee may need to monitor the daily lives of beneficiaries to determine whether they should receive distributions under the terms of the trust. The trustee should then document the circumstances that he or she considered in exercising or declining to exercise discretionary powers as discussed in §17.31. On recordkeeping, see generally §§7.13-7.52.

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§17.33 3. Uniform Principal and Income Act

The trustee's duties under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) should be discussed at the initial consultation. The attorney should emphasize to the trustee that the word "income" in this context refers to fiduciary accounting income, not "income" in the commonly used sense of the word as taxable income. See chap 8. A table detailing the allocation of items between trust accounting income and principal is provided in §7.43. The attorney should usually also include a discussion of the power to adjust between principal and income, and the unitrust conversion power specifically. See §§8.3A-8.3E.

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§17.34 4. Uniform Prudent Investor Act

As a preliminary issue, the attorney should consider whether the terms of the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) apply at all times under the terms of the trust instrument. Other sections of the Probate Code also affect the duties of a trustee relative to trust investments. On the trustee's standard of care, see §17.35. On the duty to review trust assets, see §17.36. On the need to document investment decisions, see §17.37. On delegation of investment decisions, see §17.38. On developing an investment strategy, see §17.39. On the duty to diversify, see §17.40. On social responsibility, see §17.41. For a complete discussion of the duties of a trustee relative to investments and management of trust assets, see chap 5.

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§17.35 a. Standard of Care

Probate Code §16047 provides the prudent investor standard of care (distinct from the trustee's basic standard of care) under California's version of the Uniform Prudent Investor Act. See §§2.49-2.52. See also §§5.2-5.5.

While this provides the standard of care for trustees generally, trustees with special skills may be held to a higher standard under Prob C §16014. See §2.51.

An extension of this concept is that a professional fiduciary must meet a higher standard of care than a lay person. See §5.4.

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§17.36 b. Review Trust Assets

One of the first actions a trustee should take is to carefully review the assets of the trust within a reasonable time, with a view to disposing of unproductive assets. Prob C §16049. See §§5.6, 5.13. The Probate Code does not define "a reasonable time," but it is better for the trustee to err on the side of caution and review the assets at the earliest possible juncture.

NOTE: When a national bank is serving as trustee, it must conduct a review within 60 days of the funding of the trust. See §5.22. While this methodology may be appropriate even when the trustee is not a bank, it should be noted that 60 days is the outer limit for this review to occur even for a bank. If at all possible, this review should be completed sooner.

In conducting the initial review of the trust investments, the trustee should keep in mind the duty to keep control of and preserve trust property. Prob C §16006. Consequently, the trustee should review the title to assets and take appropriate actions to retitle assets that properly should be part of the trust.

The trustee also should be aware of the duty to make trust property productive. Prob C §16007. The trustee generally is required to exercise prudence in selecting investments or an agent to which investment decisions will be delegated. The productivity of the currently held assets is a factor to be considered in this context.

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§17.37 c. Document Investment Decisions

The Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) was designed to reduce the role of hindsight in selecting investments; however, trustees may nevertheless be required to defend their decisions should the investments perform poorly. It is imperative that the trustee produce contemporaneous documents reflecting the relevant factors that were considered and the logic underlying the resulting decisions. Particular emphasis should be placed on the factors listed in Prob C §16047(c). See §§5.23-5.27. On preparing a written investment plan, see §17.57.

The creation of contemporaneous records requires that documentation be produced in every case as part of the "best practices" standard of portfolio management, because it cannot be predicted whether the investments of a particular trust will fair poorly. In other words, the trustee must treat every case as though it will be litigated. See Hartog & Dirkes, California Trust Practice §7.10 (1998).

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§17.38 d. Delegation of Investment Decisions

Once the initial review has been completed, the trustee must implement his or her investment decisions. In the case of a nonprofessional fiduciary, the selection of appropriate investments may require the delegation of investment decisions described in Prob C §16052. See §2.19. Several aspects of this statute warrant further discussion.

A trustee will not be absolved of liability solely by reason of delegating investment decisions. Subsections 16052(a)(1) and (a)(3) require that the trustee exercise prudence both in the selection of the agent and monitoring of the agent's performance. Moreover, §16052(a)(2) requires that prudence be exercised in delineating the scope and terms of the delegation. For a list of items to consider in the written guidelines defining the scope and terms of the delegation, see §5.33.

Once authority has been delegated to an agent, §16052(b) provides that the agent will have the burden of exercising reasonable care, and §16052(d) provides that the agent will be subject to jurisdiction in California. As long as the trustee exercises prudence with respect to the delegation, §§16052(b) and 16052(c) will generally have the effect of shifting exposure from the trustee to the agent. See §5.21.

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§17.39 e. Developing an Investment Strategy

An appropriate investment strategy will take into account specific circumstances of the trust and its beneficiaries, the factors listed in Prob C §16047(c), and the costs of various investments. See §5.26. A full analysis of all factors relevant to developing investment strategies is beyond the scope of this discussion. Indeed, such an analysis would likely fill many volumes. The appropriate strategy will likely depend on the intended level of current distributions and the expected duration of the trust. However, diversification is normally a key factor in any investment strategy. See §17.40. That said, it is not always necessary to diversify. Diversification may not be necessary if the assets of the trust are small, the investment horizon is very short, or other factors warrant investment in single type of asset. See §5.31.

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§17.40 f. Duty to Diversify

Generally speaking, a trustee has a duty to diversify investments "unless, under the circumstances, it is prudent not to do so." Prob C §16048. See §5.8. A broad range of factors must be taken into account in determining whether assets are adequately diversified, including the size, terms, and purposes of the trust, and representation of different asset classes. See §5.30.

NOTE: The duty to diversify assets may present particular challenges when the decedent owned a business that is the primary asset of a trust. Although there may be a temptation to retain what has been a very successful business, concentration of family wealth in a single class of asset is almost certain to result in a decline in asset values. See Ellis, Hartog, Wolf & Gifford, *Issues in Trust Administration and Experiences of Professional Trustees: Applying Prudent Investor Act and Principal and Income Act Adjustment Powers*, Estate Planning 2005 §9.13 (Cal CEB 2005) (only 54 of the names on the Forbes 400 in 1982 remained on the list in 2003, mostly due to concentrated stock positions).

Moreover, even if a trust clause provides that the trustee has "absolute discretion" in selecting the investments of a trust, that may not be sufficient to insulate a trustee from liability. *Estate of Collins* (1977) 72 CA3d 663, 672, 139 CR 644. See §5.32. See also Cline, *The Written Investment Plan: Advising Trustees on Investment Planning*, Estate Planning 2008 §9.10 (Cal CEB 2008). Conversely, even if a trust contains a clause requiring the trustee to retain a particular asset rather than diversify assets, a trustee may petition the court for instructions or to modify the trust based on changed circumstances. Prob C §§15409, 17200(b). See §16.18.

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§17.41 g. Social Responsibility

The extent to which a trustee may consider social responsibility, as opposed to overall return on an investment, may present difficult issues. This is especially true when the terms of a trust are silent and beneficiaries are unable to provide consent. For example, what would the trustee's duties have been regarding a trust that held assets invested in South Africa during Apartheid? See, *e.g.*, *Associated Students of Univ. of Or. v Oregon Inv. Council* (Or App 1986) 728 P2d 30. Some would argue that, under most circumstances, the analysis is strictly monetary. See Restatement (Third) of Trusts §90, Comment c (2007) ("in managing the investments of a trust, the trustee's decisions ordinarily must not be motivated by a purpose of advancing or expressing the trustee's personal views concerning social or political issues or causes").

Others believe that trustees should take moral considerations into account. This debate is analogous to the one regarding the role of corporations in society. See 4 Scott & Ascher on Trusts §19.1.13 (5th ed 2007): "Just as corporations and their directors are part of the community, so are trusts and trustees. Thus, concludes the argument, in deciding whether to invest in or retain a corporation's securities, trustees may properly consider the corporation's social performance."

Even if the prudent investor rule did not permit the trustee to take social responsibility into account when making investment decisions, it is clear that a trust can be drafted to include a provision to the contrary. Prob C §16046(b) (settlor may expand or restrict the prudent investor rule through express provisions in the trust instrument). See §5.28 (required retention of trust assets). Thus, a trust could prohibit investment in corporations that produce tobacco, pollute the environment, or engage in other activities the settlor opposes. However, if the trust is silent and the consent of beneficiaries cannot be obtained, it remains unclear whether the trustee may make moral decisions in selecting investments.

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§17.42 5. Accounting Requirements

The attorney should consider what the trust provides regarding accounting requirements. Some trusts may require the current beneficiary to account to contingent remainder beneficiaries under Prob C §16062(a) even if the remainder beneficiaries are not permissible beneficiaries until the death of the current beneficiary. See §7.54A.

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§17.43 6. Obtain Appropriate Insurance

Most trustees will recognize when property or liability insurance is appropriate. This may be one of the first items a trustee will consider if, for example, a residence is held for the use of a beneficiary. However, other types of insurance should not be overlooked when permissible under the terms of the trust. Health insurance should be considered even when current beneficiaries already have coverage. Disability and long-term care insurance should also be considered when appropriate. This will permit insurance to pay for certain expenses of a current beneficiary and avoid dissipating the assets of the trust.

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Source: Estate Planning/California Trust Administration/17 Long-Term Trust Administration/§17.44 F. Identify Additional Documents Required and Schedule Follow-Up Meeting

§17.44 F. Identify Additional Documents Required and Schedule Follow-Up Meeting

Any relevant documents not provided by the trustee before the first meeting should be requested at the conclusion of the initial consultation. Any additional information required should also be identified, and a follow-up meeting should be scheduled at the conclusion of the first meeting to motivate all concerned to move forward immediately.

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IV. ACTIONS FOLLOWING INITIAL MEETING

§17.45 A. Prepare Minutes of Initial Consultation

The results of the initial consultation should be documented and minutes of the meeting prepared. Many items (such as drafting written fee agreements and calendaring deadlines) are common to virtually all attorney-client relationships, but these actions are nonetheless necessary. Other documentation is unique to the area of trust administration. In particular, the trustee should contemporaneously document investment decisions and compliance under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054). See §17.57.

The minutes may protect the trustee in several ways. Records that were prepared well before litigation begins will likely be given more credence than statements made after litigation has already started. Also, the minutes may be used to refresh the recollection of the trustee in the future. A long-term trust administration may continue for many years, and the trustee may not be able to recall what was discussed in previous meetings. A review of the minutes may prevent the trustee from having to "reinvent the wheel." If the trustee dies or becomes incapacitated, the minutes will also assist the new trustee in taking over the affairs of the trust.

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§17.46 B. Prepare Trust Administration Memorandum

Handling a trust administration generally involves a learning process, which can be reinforced by a written summary of the basic operations of the trust as recommended in §17.8. Providing the trustee with a trust administration memorandum is a critical step in the process of educating the trustee. This document can also be a useful tool for informing the trustee's advisors regarding the operation of the trust. For a sample trust administration memorandum for a single-settlor trust, see §13.109.

There is a difference between understanding information and internalizing it. A trustee may understand the operation of the trust as it being explained, but may have difficulty recalling the specifics even hours later, prompting the client to call, saying, "I know we talked about this, but what does the trust mean where it says… ?" A written memorandum will refresh the trustee's recollection and reinforce the learning process.

The trust administration memorandum serves a similar function with respect to accountants and advisors, ensuring that all members of the team are "on the same page." Ideally, the trust administration memorandum should be provided to the trustee and advisors at the earliest possible stage of the administration.

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§17.47 C. Review Actions of Former Counsel

When the trustee was previously represented by another attorney, it should not be assumed that former counsel properly administered the trust. The attorney should conduct a due diligence examination of the records to determine whether anything was overlooked. The failure to identify and advise a client of malpractice by a former attorney may itself be malpractice. Putting aside the issue of malpractice liability, a competent attorney should be proactive in identifying mistakes. Matters for review may include notices (see §17.48), GST exemption allocations (see §17.49), subtrust funding (see §17.50), principal and income allocations (see §17.51), accountings (see §17.52), tax returns (see §17.53), and mandatory income distributions (see §17.54).

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§17.48 1. Notices to Interested Parties and Governmental Entities

Most attorneys who practice in the area of trust administration are aware that the notice required by Prob C §16061.7 should be sent to named beneficiaries and heirs, but even a competent attorney may have overlooked a particular person entitled to notice. This mistake may be revealed by something as basic as a comparison of the list of beneficiaries and the names of persons to whom notice was given. The attorney should also consider whether notice was or should have been given to persons initially named in a trust but deleted by a subsequent amendment. See §§2.5-2.12, 7.20. See also Lamping, *The Trustee's Million Dollar Question: Who Should Get Notice of a Trust Administration?*, 13 Cal Tr & Est Q 33 (Spring 2007).

NOTE: Even when the notice required by Prob C §16061.7 was properly provided when the trust became irrevocable, an additional notice may be required if there has been a change of trustees. It is the obligation of the continuing or successor trustee to serve the notice in that event. Prob C §16061.7(a)(2). Compliance with Prob C §16061.7 is especially important because the trustee may be held liable for all damages, attorney fees, and costs resulting from the failure to make a reasonably diligent effort to serve the required notice. See §2.11.

Consideration should also be given to whether notice has been given to known creditors of the trust and certain governmental entities. See chap 10.

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§17.49 2. Severance of Trusts with Mixed Inclusion Ratios

Particular attention should be paid to the generation-skipping transfer (GST) exemption allocation on the estate tax return under IRC §2632. The records should be examined to determine whether the trust was divided if the amount transferred to the trust exceeded the available GST exemption. See §§14.45-14.56. Any division language in the trust should be reviewed to determine what options the trustee may have with respect to the division of trusts for GST tax purposes. A qualified severance may be used when the trust is silent. IRC §2642(a)(3). See §12.74B.

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§17.50 3. Appropriate Allocation and Actual Funding of Subtrusts

Some issues may require a more sophisticated analysis. One of the most common errors in trust administration is the improper funding of subtrusts on the death of the first spouse. See chap 14. When the beneficiaries of each subtrust are different, improper funding may divert assets from one class of beneficiaries to another. This problem may be particularly dangerous for the trustee when fertile ground for litigation already exists, as in the case of a dysfunctional or blended family.

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§17.51 4. Improper Principal and Income Allocations

Improper allocations between trust accounting income and principal may have affected the distributions received by mandatory income beneficiaries such as a surviving spouse in the case of a QTIP trust. See chap 8. The attorney should carefully document any such errors or other failures to make mandatory distributions and cause overdue distributions to be made as soon as possible. See §17.54.

When trust accounting income that should have been distributed instead continued to compound inside the trust, a distribution of only the original undistributed amount may unfairly benefit the remainder beneficiary. Depending on the amounts involved, this is may be a situation in which a petition for instructions or Prob C §17200 petition may be appropriate. For a sample form of petition, see §14A.5.

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Source: Estate Planning/California Trust Administration/17 Long-Term Trust Administration/§17.52 5. Completion of Required Accountings

§17.52 5. Completion of Required Accountings

Counsel should review the records of the trust to determine whether required accountings for previous periods have been completed. See §§7.53-7.55C.

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§17.53 6. Filing of Required Tax Returns

Depending on the stage at which a new attorney comes into a case, the termination of an IRC §645 election may be a relevant consideration. The election begins on the date of the decedent's death and terminates on the day before the "applicable date" (2 years after the date of death if no Form 706 is required to be filed, or the later of 2 years after the date of death or the day that is 6 months after the date of final determination of estate tax liability). See §11.53.

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§17.54 7. Overdue Mandatory Income Distributions

When the trust instrument provides for mandatory income distributions, counsel should compare fiduciary accounting income as revised (see §17.51) with previous distributions to income beneficiaries. The amount of any mandatory income distributions still owed may then be calculated and distributed.

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§17.55 D. Update Spreadsheet of Trust Assets and Liabilities

The spreadsheet listing the assets and liabilities of the trust should be updated following the initial consultation, and periodically thereafter. Unlike the values used for accountings (see chap 7), fair market value should be used instead of book value. This spreadsheet is intended to provide a snapshot of the trust's current financial position as an informal management tool. It is perfectly acceptable to use estimated values for particular assets that do not have a readily ascertainable value, such as certain real estate. See sample spreadsheets in §§14.85-14.100.

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§17.56 E. Communicate and Meet With Advisors

As the attorney is completing the review process and shifting into the implementation stage, it is advisable to meet with the trustees and the advisors to review the action plan. The meeting will give everyone the opportunity to voice any concerns or raise any additional issues that must be resolved. The spreadsheet of trust assets and liabilities should be reviewed for accuracy and completeness at this meeting. See §17.55. This review may raise additional issues, such as assets that remain to be collected. Minutes of the meeting should be prepared and circulated to all participants to avoid any misunderstandings, and a follow-up meeting should be scheduled at the conclusion of the implementation phase to review the actions taken and identify any loose ends.

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§17.57 F. Prepare Written Investment Plan

Much of the documentation required in a long-term trust administration is dictated by the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054). See chap 5. The requirements of the UPIA are discussed in the sample trust administration memorandum in §14.15B. The philosophy underlying the adoption of the prudent investor rule has been summarized as follows in Restatement (Third) of Trusts §90, Comment b (2007):

> The trustee's compliance with these fiduciary standards is to be judged as of the time the investment decision in question was made, not with the benefit of hindsight or by taking account of developments that occurred after the time of a decision to make, retain, or sell an investment. The question of whether a breach of trust has occurred turns on the prudence and propriety of the trustee's conduct, not on the eventual results of investment decisions. The trustee is not a guarantor of the trust's investment performance.

The purpose of the written investment plan is to document the standards applied by the trustee at the time particular investment decisions were made. This will permit the trustee to establish the reasonableness of the approach taken, even if the particular investments selected do not perform well. It is particularly important that this documentation be produced contemporaneously with the initial investment decisions, because statements made after investment declines may be perceived as self-serving. For further discussion, see Cline, *The Written Investment Plan: Advising Trustees on Investment Planning*, Estate Planning 2008, chap 9 (Cal CEB 2008).

The trustee should be aware that the attorney's role is not to advise the trustee regarding investment strategies, but rather to advise the trustee regarding the documentation that must be prepared to memorialize the investment decisions made by the trustee. See §17.37. Regardless of what is required of a trustee in particular case, the trustee should be aware of the potential liability arising from the failure to maintain adequate records. See discussion in §7.2.

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§17.58 G. Identify Issues for Which Court Confirmation or a Notice of Proposed Action Would Be Appropriate

The trustee should consider obtaining court approval for investment strategies under Prob C §17200. Court approval also may be obtained when investment decisions are delegated. In that event, written delegation guidelines should be included in the petition. This requires that the guidelines be approved by the investment advisor in advance. Otherwise, any modifications required by the advisor as a condition of accepting the engagement will require an additional petition. For a sample form of petition, see §14A.5.

Other actions contemplated by the trustee also may be appropriate for court approval. The more likely that some liability will be attached to a particular action, the greater the need for court approval. When beneficiaries with divergent interests are especially litigious, the trustee may wish to seek advance court approval for use the notice of proposed action for virtually every discretionary action. For a form of notice of proposed action, see §14A.4.

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§17.59 H. Identify Additional Actions Required to Complete Implementation Phase of Administration

The precise nature of the actions required to position a trust estate for a long-term administration will vary greatly from case to case. However, there are invariably certain loose ends that are specific to each particular case. The comments of other advisors, such as CPAs and investment advisors, are often particularly helpful in preventing oversights.

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§17.60 I. Prepare Team Management Chart

A team management chart is especially useful to track assignments that are given to the various participants in the administration. This need not be limited to those with formal roles, such as CPAs and attorneys, but may also include family members or others who are informally providing assistance. The purpose of this chart is to ensure that tasks do not slip through the cracks and to provide accountability by setting deadlines. A sample chart is provided in §17.69. This chart should be reviewed at each meeting with the trustee and advisors.

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§17.61 J. Meet Again With Trustee and Advisors as Needed to Complete Implementation Phase of Administration

Depending on the complexity of the administration, it may take several meetings to position a trust for a long-term administration. Once this has been accomplished, further meetings should be scheduled to periodically review the administration. Typically, these status meetings will involve issues such as monitoring investment and distribution decisions, as well as tax compliance issues, although other issues may arise.

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V. TRUST MAINTENANCE

§17.62 A. Schedule Regular Meetings to Review Administration

The trustee should meet with the attorney at least once a year (and during the first year, perhaps quarterly). Trusts that are more labor intensive or require close monitoring may call for more frequent meetings. These meetings permit the attorney to monitor the trustee's actions and also serve to remind the trustee to remain diligent regarding documentation and fiduciary duties.

A periodic trust maintenance meeting will permit the attorney and trustee to review the documentation provided by the trustee to determine whether the administration is staying on track. For example, a review of the minutes of trustee-beneficiary meetings not only may reveal the frequency with which the meeting occurred but also may indicate potential problems. Particular attention should be paid to documentation relating to discretionary distributions. See §§17.23-17.29.

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§17.63 B. Review Investments and Prepare Documentation

It is essential to document the periodic review of the trust investments, and an annual review provides a convenient occasion for this. The rationale for retaining investments or continuing to delegate to an investment manager must be memorialized, particularly when performance may be questionable. See §17.36.

Any explanations by the trustee in the context of a lawsuit will appear self-serving and will likely carry little weight. Contemporaneous documentation is therefore crucial to insulating the trustee from liability. Because the carrying value of assets in the trust accounting may be different from the fair market value of trust assets, the attorney should update the asset spreadsheet to ensure that the attorney has an accurate picture of the trust's financial position. See §17.55.

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§17.64 C. Prepare Account and Report

The trustee is required to provide an account and report to the beneficiaries at least annually, and in some cases more often. An annual accounting is the minimum standard. In some cases, the trustee is required to provide additional information. See chap 7. Certain related transactions may be completed contemporaneously with the annual accounting. Following the preparation of each accounting, the trustee should consider whether it is appropriate to obtain court approval under Prob C §17200.

The trustee may consider whether adjustments should be made between fiduciary accounting income and principal (or past adjustments may be reviewed for continuing appropriateness). See §17.51. Mandatory distributions may be scheduled and arrangements made for the filing of tax returns.

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§17.65 D. Consider Modification or Termination of Trust

Some nonrecurring transactions should also be reviewed at the regularly scheduled annual (or quarterly) meeting. When the value of trust assets is very low, the trustee may consider requesting that the court terminate the trust. See §14A.33. The trustee should also consider whether circumstances have changed such that the terms of the trust should be modified. See chap 16.

When the value of trust assets is very low in relation to the expenses of the trust, the trustee may petition the court to order termination or modification of the trust or appointment of a new trustee if the court in its discretion determines that continuation of the trust under its existing terms will defeat or substantially impair the accomplishment of trust purposes. Prob C §15408(a). Consideration should also be given to the approaching termination of a trust under its terms, such as a beneficiary reaching a particular age. Once a trust is terminated, the trustee continues to have powers related to winding up the affairs of the trust. Prob C §15407(b).

At a minimum, the trustee will be required to file a final income tax return and prepare a final account and report. The trustee should consider petitioning the court under Prob C §17200 for approval of the account or any other potentially controversial action before making final distribution. See chap 15. If trust assets have already been distributed, the trustee may be required to pay the legal expenses incurred in subsequent litigation. See §§9.49-9.56. Following final distribution, the attorney should send the trustee a closing letter documenting that the representation has been concluded. See §13.114 for a sample form of closing letter.

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Source: Estate Planning/California Trust Administration/17 Long-Term Trust Administration/ VI. FORMS/§17.66 A. Form: Trust Administration Checklist

VI. FORMS

§17.66 A. Form: Trust Administration Checklist

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Name of Client: _____

LONG-TERM TRUST ADMINISTRATION CHECKLIST

STAGE ONE: PRE-FIRST MEETING		
NO.	**TASK**	**INITIAL/DATE**
1.	Pull standard first meeting packet and asset collection folders for attorney to use at first meeting, including fee schedules, if we did not do initial administration. If we did do initial administration, duplicate documents for ongoing trust administration file.	
2.	Identify parties and complete Beneficiary and Trust forms: Trustee Current beneficiaries Remainder beneficiaries	
3.	Perform conflict check for proposed client and each beneficiary.	
4.	Discuss obtaining TIN with attorney. If we did not do initial trust administration, assign TIN at this point or wait until after first meeting when we are sure client will hire us. TIN is included on Certificates; if one is not obtained prior to first meeting, leave blank line on form at this time.	
5.	Complete minimum information on Trust Summary, print on pink paper and place in new TA file for first meeting.	
6.	Obtain previously prepared documents: Date(s) Completed Request copies of estate planning documents _____ Estate tax return _____ Prior Accountings _____ 1041s _____ 541s _____ Notice of proposed actions Any Principal and Income adjustment actions _____ Any unitrust conversion actions _____	
7.	Determine whether Uniform Prudent Investor Act applies to trust	
8.	Prepare Intake Documents: Date(s)	

		Completed	
	Trust Administration Index	_____	
	Liability List	_____	
	Information to be Collected	_____	
	Beneficiary List	_____	
	Authorization to Disclose Information	_____	
	Trustee Time Report	_____	
	Trust Summary (Print on pink paper)	_____	
9.	Attorney to Finish Trust Summary for each trust		

STAGE TWO: INITIAL MEETING WITH TRUSTEE		
NO.	**TASK**	**INITIAL/DATE**
1.	Determine scope of representation.	
2.	Review trust instrument terms with client.	
3.	Discuss fiduciary duties with client.	
4.	Review circumstances and purpose of the trust.	
5.	Discuss any emergencies (pending litigation, needs of beneficiaries, etc.).	
6.	Determine whether action is required to collect additional assets.	
7.	Review client recordkeeping system and establish new system if necessary:	
	Financial records _____	
	Beneficiary meeting scheduling _____	
	Beneficiary meeting minutes _____	
	Confirming correspondence to beneficiaries _____	
	Journal of actions and communications _____	
8.	Review the trust assets and make decisions concerning the retention and disposition of assets to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust per Uniform Prudent Investor Act (Prob C §16049).	
9.	Discuss preliminary liquidity needs.	
10.	Determine whether the amount of trust assets warrants investment manager or delegation to a mutual fund manager.	
11.	If investment decisions will be necessary, discuss issues necessary to prepare written delegation guidelines.	
12.	Discuss concepts of trust accounting Income and Principal.	
13.	Discuss potential adjustments on conversion between income and principal:	
	Discuss Principal and Income	

	adjustment power _____ Unitrust conversion power _____	
14.	Discuss fiduciary income tax issues, including separate-share rule and DNI.	
15.	Discuss use of notice of proposed actions.	
16.	Discuss use of Prob C §17200 petition.	
17.	Discuss issues revealed by previous review.	
18.	Discuss miscellaneous client concerns.	
19.	Request previously prepared documents not provided before first meeting: Estate tax return _____ Prior Accountings _____ 1041s _____ 541s _____ Notice of proposed actions _____ Any Principal and Income adjustment actions _____ Any unitrust conversion actions _____	
20.	Schedule follow up meeting with client and other advisors.	
21.	Identify other advisors, such as CPA and investment advisors.	
22.	Discuss attorney fees.	

STAGE THREE: DOCUMENT THE FILE		
NO.	**TASK**	**INITIAL/DATE**
1.	Obtain signed fee agreement from client.	
2.	Prepare minutes of meeting with client, including a list of what actions to be taken by whom.	
3.	Document initial review of the trust assets per Uniform Prudent Investor Act (Prob C §16049).	
4.	Document consideration of circumstances of the trust per Uniform Prudent Investor Act (Prob C §16047(c)): General economic conditions The possible effect of inflation or deflation The expected tax consequences of investment decisions or strategies The role that each investment or course of action plays within the overall trust portfolio The expected total return from income and the appreciation of capital Other resources of the beneficiaries known to the trustee as determined from information provided by the beneficiaries Needs for liquidity, regularity of income, and preservation or appreciation of capital An asset's special relationship or special value, if any, to the purposes of the trust or to one or more	

	of the beneficiaries	
5.	If delegation of investment management, draft written delegation guidelines including: A summary profile of the trust and its purposes _____ The investment objectives for the assets delegated to the agent, including a statement of risk tolerance _____ Asset allocation targets _____ A description of acceptable asset class characteristics _____ A description of how performance will be measured _____ Income and/or cash flow requirements for the beneficiaries _____ Investment time horizon _____ Other liquidity needs for the trust for payment of taxes, fees, or other expenses _____ A description of the tax status of the trust, how taxes are allocated, and whether there are any special restrictions on trust investments as a result of the trust's tax status _____ An agreement of how transactions will be reported to the trustee _____ A summary description of how communications will be transacted between the agent and the trustee and how investment transactions will be approved. _____	
6.	Calendar relevant dates.	
7.	Document calculation of overdue trust accounting distributions.	
STAGE FOUR: REVIEW ACTIONS TAKEN BY PRIOR COUNSEL		
NO.	**TASK**	**INITIAL/DATE**
1.	Preliminary inventory of tasks performed by prior counsel: Will lodged with court _____ Notice to beneficiaries _____ Accountings with statutory notice to beneficiaries _____ Account and report at least annually _____ Assets properly re-titled _____ Mandatory accounting distributions made _____ Estate tax return filed _____ 1041s filed	

	1041s filed Trust split for GST purposes _____	
2.	Review Asset spreadsheet used in Administration.	
3.	Review prior accountings.	
4.	Analyze distributions made under prior counsel: Trust accounting income distributions made: _____ Trust accounting principal distributions made: _____ Compare mandatory trust accounting distributions under document with actual distributions made: _____	
5.	Review estate tax return and any supplemental returns.	
6.	Review subtrust allocations, if applicable: Ascertain formula clause _____ Review target amounts calculations: _____ Prepare list of incorrect funding actions: _____	
7.	Review income tax returns.	
8.	Review minutes of prior meetings.	
9.	Ascertain whether §645 election was made.	
10.	If §645 election was made, identify date of end of fiscal year accounting and conversion to calendar year.	
11.	Obtain TINs for subtrusts if not already obtained.	
12.	Prepare summary of previous adjustments between Income and Principal.	
13.	Ascertain whether Prob C §9202 notices were sent: Medi-Cal _____ Incarcerated beneficiaries _____	
14.	Review insurance policies: Property for Trust _____ Liability for Trust _____ Health Insurance for beneficiaries _____	

STAGE FIVE: CONTINUING INITIAL TRUST ADMINISTRATION		
NO.	**TASK**	**INITIAL/DATE**
1.	Review previously prepared documents, if not already done in Stage One: Estate tax returns _____ Prior Accountings _____ 1041s _____	

	541s _____ Notice of proposed actions _____ Any Principal and Income adjustment actions _____ Any unitrust conversion actions _____	
2.	Provide Trust Administration Memorandum to client and advisors.	
3.	Determine whether court approval should be obtained for investment strategy.	
4.	Meet with Trustee and other advisors, such as CPA and investment managers.	
5.	Prepare spreadsheet of trust assets, liabilities, and other items.	
6.	File Prob C §17200 petition (if applicable).	
7.	Send notice of proposed action (if applicable).	
8.	Locate and take possession of assets if not already completed (Prob C §16006).	
9.	Transfer title into the name of the trustee if not already completed.	
10.	Discuss possible adjustments between Income and Principal.	
11.	Make overdue mandatory trust accounting distributions.	
12.	Consider going to court under Prob C §17200.	
13.	Provide written delegation guidelines to investment manager.	
14.	Take appropriate actions re investments (*i.e.*, buying, selling, exchanging, etc.).	
15.	Identify differences between carry value and market value for trust assets.	
16.	Pay trustee compensation.	
17.	Implement modifications to trustee recordkeeping.	
18.	Hold follow-up meeting with trustee and advisors.	
19.	Sever trust for GST purposes, if necessary.	

TRUST MAINTENANCE:
AT LEAST ANNUALLY DO EACH OF THE FOLLOWING

COPY THIS FORM TO BE USED EACH YEAR DURING THE ADMINISTRATION OF THE TRUST

NO.	TASK	INITIAL/ DATE LAST COMPLETED
1.	Prepare Accounting or Waiver of Accounting.	
2.	Determine whether to obtain court approval of accounting.	
3.	Attorney to review trustee documentation re actions: Financial records _____ Beneficiary meeting scheduling _____	

	Beneficiary meeting minutes _____ Confirming correspondence to beneficiaries _____ Journal of actions and communications _____	
4.	Review financial needs of beneficiaries where distributions are discretionary.	
5.	Determine necessity of team meeting with other advisors such as CPA and investment advisors.	
6.	Update asset spreadsheet for each trust.	
7.	Evaluate investment performance with Trustee.	
8.	Review investment criteria with Trustee.	
9.	Review with Trustee documentation for investment strategy.	
10.	Document filing of fiduciary income tax returns.	
11.	Review mandatory trust accounting distribution and whether timely made.	
12.	Evaluate need for discretionary distributions for beneficiaries.	
13.	Discuss potential conversions between income and principal: Discuss Principal and Income adjustment power Unitrust conversion power	
14.	Determine whether fiduciary tax returns have been timely filed.	
15.	Review minutes of prior attorney-client meetings and prepare minutes for current period.	
16.	Evaluate whether trust should be terminated due to low principal (Prob C §15408).	
17.	Evaluate modification or termination of trust due to changed circumstances (Prob C §15409).	
18.	Remind trustee to remain diligent re documenting actions and his/her fiduciary duties.	

CLOSING TRUST

NO.	TASK	INITIAL/ DATE LAST COMPLETED
1.	Prepare final account and report.	
2.	Consider Prob C §17200 petition requesting approval of final account.	
3.	Have CPA prepare final fiduciary income tax returns.	
4.	Pay trustee and other professional fees.	
5.	Distribute assets of the trust.	
6.	Distribute reserve.	
7.	Prepare closing letter to client.	

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Source: Estate Planning/California Trust Administration/17 Long-Term Trust Administration/§17.67 B. Form: Beneficiary Financial Questionnaire

§17.67 B. Form: Beneficiary Financial Questionnaire

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TRUST BENEFICIARY FINANCIAL QUESTIONNAIRE

BIOGRAPHICAL INFORMATION	
Name:	
Address:	
Home phone:	
Cell phone:	
Work phone:	
Fax:	
E-mail:	
SSN:	
Date of birth:	
Marital status:	
Number of children:	
Relationship to Settlor:	
EMPLOYMENT INFORMATION	
Employer:	
Employer's address:	
Occupation:	
Employer's phone number:	
Date job started:	
If unemployed, date job ended:	
Hours per week employed:	

If Self-Employed:	
Form of entity (i.e., S corp, etc.):	
Date business started:	
Type of business:	

STUDENT INFORMATION	
Name of school:	
Address of school:	

Major:	
Expected degree:	
Date started at this school:	
Anticipated graduation date:	
Current number of credit hours:	
Tuition:	
Room & board paid to school:	
TAX INFORMATION	
Year of last tax return filed:	
Filing status (i.e., single, etc.):	
States returns filed (non-CA):	
Number of exemptions claimed:	

INCOME		
Description	**Last Month**	**Avg. Last 12 Months**
Salary or wages (gross, before taxes)		
Overtime (gross, before taxes)		
Commissions or bonuses		
Public assistance not listed elsewhere		
Spousal/Partner support		
Pension/retirement fund payments		
Social Security retirement other than SSI		
SSI		
SDI		
Private disability insurance		
Unemployment compensation		
Workers' compensation		
Other (military BAQ, royalty payments, etc.) (specify):		
Dividends/interest		
Rental property income		
Other trust income		
Other income		
TOTAL		
DEDUCTIONS AND EXPENSES		
		Avg. Last 12

Description	Last Month	Months
Required union dues		
Required retirement payments (not Social Security, FICA, 401(k), or IRA)		
Medical, hospital, dental, and other health insurance premiums (total monthly amount)		
Child support		
Spousal or partner support		
Necessary job-related expenses not reimbursed by employer		
Rent/Mortgage (circle one)		
(If mortgage) average principal		
(If mortgage) average interest		
Real property taxes		
Homeowner's or renter's insurance (if not included above)		
Maintenance and repair		
Health-care costs not paid by insurance		
Child care		
Groceries and household supplies		
Eating out		
Utilities (gas, electric, water, trash)		
Telephone, cell phone, and e-mail		
Laundry and cleaning		
Clothes		
Education		
Entertainment, gifts, and vacation		
Auto expenses and transportation (insurance, gas, repairs, bus, etc.)		
Insurance (life, accident, etc.; do not include auto, home, or health insurance)		
Savings and investments		
Charitable contributions		
Installment payments (see below)		
TOTAL		
Amount of expenses paid by others:		

Installment Payments				
Paid to	**For**	**Amount**	**Balance**	**Date of Last Payment**

ASSETS/DEBTS		
Description	**Value**	**Amount Owed**
Real Estate (give street addresses)		
Household Furniture, Furnishings, Appliances		
Jewelry, Antiques, Art, Coin Collections, Etc.		
Vehicles, Boats, Trailers		
Savings Accounts		
Checking Accounts		
Credit Union, Other Deposit Accounts		
Cash		
Tax Refund Not Yet Received		
Life Insurance With Cash Surrender or Loan Value		
Stocks, Bonds, Secured Notes, Mutual Funds		
Retirement and Pensions		
Profit-Sharing, Annuities, IRAs, Deferred Compensation		
Accounts Receivable and Unsecured Notes		
Partnerships and Other Business Interests		
Other Assets		
Student Loans Owed		
Taxes Owed		
Loans Owed—Unsecured		
Credit Cards Owed		
Other Debts Owed		
TOTAL		

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Source: Estate Planning/California Trust Administration/17 Long-Term Trust Administration/§17.68 C. Form: Table of Trustee Duties

§17.68 C. Form: Table of Trustee Duties

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TABLE OF TRUSTEE DUTIES		
Duty	**Probate Code Section**	**Brief Description**
Duty to administer trust	§16000	You have a duty to follow the terms of the trust and the law governing the administration of trusts.
Duty of loyalty	§16002	You have a duty to administer the trust solely for the benefit of the beneficiaries of the trust.
Duty to deal impartially with beneficiaries	§16003	You have a duty to not favor the interests of one beneficiary over another, except to the extent that the trust provides to the contrary.
Duty to avoid conflict of interest	§16004	You have a duty to avoid transactions with the trust that will benefit you personally.
Duty not to require beneficiary to relieve trustee of liability	§16004.5	You cannot require a beneficiary to waive their rights as a condition of distribution.
Duty not to undertake adverse trust	§16005	You may not act as trustee of any other trust that has a competing interest with this trust.
Duty to take control of and preserve trust property	§16006	You must marshal trust assets and take reasonable steps to preserve them.
Duty to make trust property productive	§16007	Subject to certain exceptions, you have a duty to make the trust assets profitable. The subject of trust investments is complicated, and we will discuss this area with you in detail.
Duty to keep trust property separate and identified	§16009	This is one of the most important duties you have. You have a duty to keep the assets and debts of the trust separate from your own. In other words, you should not commingle funds.
Duty to enforce claims	§16010	You must take reasonable actions to pursue amounts that may be owed to the trust.
Duty to defend actions	§16011	You have the duty to take actions to prevent a loss to the trust, such as by defending a lawsuit.
Duty not to delegate; exception	§16012	Subject to certain exceptions, you must perform actions on behalf of the trust yourself rather than having others act on behalf of the trust.

Duty with respect to cotrustees	§16013	If you serve along with a cotrustee, you each have a duty to participate in the administration and prevent the other from committing a breach of the trust.
Duty to use special skills	§16014	In managing the trust property, you must use at least ordinary business ability. However, if you have special skills, you will be held to a higher standard of care.
Duty to provide information to beneficiaries	§§16060-16064	You have a number of duties related to providing financial and other information to beneficiaries (and in some cases, the settlor's family members). We will discuss these duties with you in detail.
Discretionary powers to be used reasonably	§§16080,16081	Even if the trust provides that a particular action is entirely within your discretion, you have a duty to act reasonably in exercising that discretion.

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Source: Estate Planning/California Trust Administration/17 Long-Term Trust Administration/§17.69 D. Form: Team Management Chart

§17.69 D. Form: Team Management Chart

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SINGLE FAMILY TRUST ADMINISTRATION

Trust Administration Team Management Chart - Action Steps

Next Client meeting: 10/15/08
Next Advisor Meeting: 10/15/08
Next Internal Meeting: 9/15/08

Item No.	Description	Date Assign.	Date Due	Date Comp.	Trustees FT	Trustees BT	Attorney Internal Team DG	Attorney Internal Team CC	Attorney Internal Team JL	Attorney Internal Team MM	Attorney Internal Team PA	Attorney Internal Team PO	CPA AB	CPA XZ	Financial EF	Advisors GH
	ONGOING								x		x					
1	Update Team Management Chart		Weekly													
2	Distribute Updated Team Management Chart		Weekly						x		x	x				
3	Maintain Trust Administration File		Daily						x		x	x				
	ACTION STEPS															
1	Obtain Income Figures for 123 Main Street Property	1/15/08	2/15/08	2/10/08									x			
2	Prepare Income Projections	1/15/08	3/15/08	2/15/08										x		
3	Prepare Income Tax Returns	1/15/08	4/15/08	3/20/08									x	x	x	x
4	Provide Estate Tax Return for Review	1/15/08	4/15/08	2/15/08									x			
5	Prepare Accounting	1/15/08	6/15/08	6/10/08									x			
6	Draft Petition to Approve Accounting	1/15/08	9/15/08	9/1/08					x	x						
	TEAM MEETINGS / ADVISOR MEETINGS															
1	Team Meeting	7/30/08	8/5/08	8/5/08			X	X			X	X	X	X		
2	Advisor Meeting	7/30/08	8/6/08	8/5/08			X	X			X	X	X	X		
	COMPLETED ACTION STEPS AND MEETINGS															
1	Schedule team meeting	7/30/08	8/5/08	8/1/08							x	x				
2	Schedule advisor meeting	7/30/08	8/6/08	8/1/08							x	x				
3	Create Team Management Chart	1/15/08	2/5/08	2/5/08												

KEY:
Full Names Corresponding to Initials Above

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